OVERVIEW:
Company Summary
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PRESENTATION
Operator
Good morning, and welcome to Dover’s Third Quarter 2023 Third Earnings Conference Call. Speaking today are Richard J. Tobin, President and Chief Executive Officer; Brad Cerepak, Senior Vice President and Chief Financial Officer; and Andrey Galiuk, Vice President, Corporate Development and Investor Relations. (Operator Instructions) As a reminder, ladies and gentlemen, this conference call is being recorded, and your participation implies consent to our recording of this call. If you don’t agree with these terms, please disconnect at this time. Thank you.

I would now like to turn the call over to Mr. Andrey Galiuk. Please go ahead, sir.

Andrey Galiuk  Dover Corporation - VP of Corporate Development & IR
Thank you, Angela. Good morning, everyone, and thank you for joining our call today. An audio version of this call will be available on our website through November 14, and a replay link of the webcast will be archived for 90 days. Our comments today will include forward-looking statements based on current expectations. Actual results and events could differ from those statements due to a number of risks and uncertainties, which are discussed in our SEC filings. We assume no obligation to update our forward-looking statements.

With that, I will turn this over to Rich.

Richard Joseph Tobin  Dover Corporation - President, CEO & Director
Okay. Thanks, Andrey. We posted very encouraging results in what is -- dynamic operating environment across our different end markets and geographies. Revenue and order rates improved sequentially in the quarter on normalizing lead times and inventories, improving demand across several end markets and a return to normal seasonality. Our backlog continued to normalize in the quarter, in tandem with lead times as we shipped longer-dated orders from our books.
Broadly speaking, margin performance in the quarter was exceptional, reaching an all-time high driven by productivity, cost controls and disciplined pricing, which more than offset the negative product mix in Pumps & Process Solutions. The proactive structural cost actions we have undertaken over the last 12 months are paying divdes and should support strong margin conversion going forward.

Our recent portfolio moves, the acquisition of FW Murphy the sale of DESTACO followed the portfolio intent and priorities that we reiterated at our Investor Day earlier in the year and continued portfolio evolution towards higher growth and higher return businesses at attractive valuations. Our balance sheet position and cash flow are strong and provide attractive optionality as we continue to pursue bolt-on acquisitions in a more favorable M&A environment and evaluate opportunistic capital return strategies.

We have reduced our EPS guidance for the full year and are now targeting the low end of the previous guidance range. This is driven by continued lag in biopharma recovery that we expected to happen in the second half of the year, temporary cost and supply chain issues that I'll expand upon later and a general trend towards inventory liquidation across supply chains as a result of macro uncertainty and prohibitive carrying costs, I'll cover the specifics in the segment commentary.

Overall, demand remains good across the portfolio, considering the plentiful negative macro headlines. Our new product launches and capacity additions and identified areas of growth are all on track, and we expect that our fourth quarter production posture will help balance our channel inventories while prevailing demand, lead times and inventory carrying costs by the end of 2023. We are increasingly convinced that inventory position will be critical to the pricing dynamic and financial results moving into 2024.

Going into 2024, we expect to see growth in our bookings driven by secular growth exposed and recovering end markets, and we expect to carry an elevated backlog into next year in select businesses. Between our demand outlook, flexible business model and in-flight structural cost actions, we see good foundation for our value creation in 2024.

Let’s move on to the performance highlights on Page 4. Consolidated revenue was down 2% in the quarter despite sequential growth in 4 out of 5 segments. Bookings were up sequentially, but down 4% organically year-over-year, resulting in a book-to-bill of 0.93, reflecting better lead times and strong shipments against our longer-dated orders. As a result, our backlog continued to normalize, but remains elevated relative to prepandemic levels.

Segment margins were up 50 basis points to 21.7%, a record since the Apergy spin as broadly based productivity and portfolio improvements were more than able to offset biopharma mix. Adjusted EPS was up 4% to $2.35 in the quarter and positive price/cost dynamics, together with cost containment actions, strong execution, more than offset lower volumes.

Let’s go to Slide 5. Engineered Products was down 3% organically in the quarter. General weakness in Europe and Asia, together with lower shipments in vehicle service, more offset the record quarter in aerospace and defense and strong shipments in waste hauling. Order rates in the segment were up 12% organically in the quarter, primarily driven by waste handling business, which continues to take capacity reservations well into 2024. Margins at 20% were up 260 basis points year-over-year driven by a better mix of recurring and aftermarket revenue, price/cost and productivity investments made in previous periods.

I’d like to mention the announcement of our agreement to divest DESTACO, one of the operating units within the Engineered Products segments and an attractive valuation. This is not related to (inaudible) performance, but believe the valuation we achieved underscores the quality and strong performance of the businesses that we have proven to have best-in-class operating margin and less cyclicality than typical capital goods businesses.

Clean Energy & Fueling revenue was flat organically in the quarter. We saw double-digit growth in components for LNG and hydrogen markets. And the above-ground retail fueling business returned to growth as opposed EMV recovery is in progress. High interest rates led to project pushouts in vehicle wash and an unforecasted channel destocking has resulted in slower activity in LPG components and below ground fueling, which are highly margin accretive to the segment. Margins in the quarter were up -- were at 20%, were up 40 basis points on structural cost actions in our retail fueling business and solid execution more than offset negative mix.
Imaging & ID was down 4% organically as slowing demand in China and a difficult comparable period in marking and coding printer shipments more than offset the growth of serialization software and marking and coding consumables and professional services. Margins in Imaging & ID was strong at 26%, though down year-over-year against an all-time record high for the segment in the comparable quarter.

Pumps & Process Solutions was down 7% organically in the quarter. Precision Components and hygienic dosing systems posted another quarter of excellent growth, but were more than offset by the continued softness in biopharma. Industrial pumps and polymer processing were stable in the quarter. Segment margin of 27% was down to the lower mix of biopharma revenue.

Top line in Climate & Sustainability Technologies up 2% organically. CO2 systems continued its double-digit growth trajectory. Heat exchanger shipments remained strong in North America and Europe, though we experienced the beginning of demand headwinds in Asia. The segment posted strong margin performance of 18% in the quarter with our food retail business or refrigeration business operating at a robust 15% margin. The steady margin improvement trajectory in refrigeration has been noteworthy as positive mix and productivity investments have driven excellent margin conversion. We expect the margin improvement trend to continue for the whole segment.

I’ll pass it on to Brad here.

Brad M. Cerepak - Dover Corporation - Senior VP & CFO

Thanks, Rich. Good morning, everyone. I’m on Slide 7. The top bridge shows our organic revenue decline of 2%. Both acquisitions and FX translation contributed positive 1% to the top line in the quarter. FX, which has been a headwind for the past 1.5 years resulted in $0.02 of positive EPS impact in the quarter. Based on recent movement in the euro-dollar exchange rate, we now expect FX to be a $0.01 to $0.02 headwind in the fourth quarter.

From a geographic perspective, the U.S., our largest market, is down 7% in the quarter due to lower shipments in vehicle service, biopharma, LPG components and below-ground retail fueling. Europe was down 5% and Asia was down 3%. China, which represents about half of our revenue base in Asia, was down 5% organically in the quarter. On the bottom chart, bookings were down year-over-year due to normalization of lead times and strong shipments against elevated backlogs.

Now on our cash flow statement, Slide 8. Year-to-date, free cash flow came in at $688 million or 11% of revenue, represented an increase of nearly $400 million year-over-year. As discussed previously, with supply chains improving, we have begun actively working to liquidate our working capital balances in 2023. We accelerated our inventory reduction in the third quarter and expect the trend to continue as we plan to balance our inventory levels by the end of the year.

Free cash flow generation has historically peaked in the fourth quarter. And again, we expect strong fourth quarter cash flow to finish the year. Our forecast for 2023 free cash flow is 13% to 15% of revenue.

Let me turn it back to Rich.

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

All right. I’m on Slide 9. We expect Engineered Products to generate moderate growth in the fourth quarter. Aerospace and defense should remain strong. Meanwhile, the auto strike will weigh on several businesses in the near term. Growth in our waste handling business, which is expected to be robust in the fourth quarter into ’24, will be reduced in near term by recent strike at a major truck OEM impacting deliveries.

Shipments in vehicle aftermarket expected to be lower versus a record previous year on higher interest rates weigh on service shops ability to finance CapEx. We expect margins to improve in the quarter on positive price/cost tailwinds and benefits from our recent productivity capital investments.
Clean Energy & Fueling is expected to remain steady. Clean energy, LNG and hydrogen components should continue their robust trajectory and order trends in aboveground retail fueling point to continued post EMV recovery. We expect channel destocking and interest rate-driven headwinds in the below-ground fueling segment, LP components and vehicle wash to maintain through year-end. We expect stable margin performance as the $60 million in aggregate structural cost containment actions in retail fueling should offset negative mix from lower below-ground and lower car wash volumes.

Imaging and ID is expected to be down organically against a difficult comparable period driven by slowing demand in Asia and a subdued outlook for textiles. Serialization software should continue its growth trajectory on new customer conversion. Margin performance should remain at attractive levels at this segment.

Pumps & Process is expected to remain roughly flat organically in the fourth quarter. Precision Components should continue growth tailwinds from energy transition projects. Polymer processing is booked for the year. The recovery in biopharma components have been very subdued. And although channel inventory levels are now below prepandemic levels, end customer demand has not recovered enough to drive 2023 growth despite earlier forecast indicating recovery.

We have reduced our production and inventory levels appropriately and will remain in this posture for the balance of the year. This is generally a short-cycle business, and we can ramp as order rates recover in '24. We expect year-over-year margin headwinds on negative mix in biopharma.

After several years of impressive top line growth, Climate & Sustainability Technologies expect to moderate in the fourth quarter as demand for heat exchanges abruptly slowed in Q3 due to near-term uncertainty in European heat pumps. As a result, we’re reducing production levels to allow for inventory to be cleared in the fourth quarter. Traditional refrigeration demand will retain its seasonality with reduced activity during the holiday season. But we continue to see robust demand for our CO2 refrigeration systems and are ramping up production and go-to-market efforts appropriately. We expect continued year-over-year margin improvement through year-end on productivity gains and improved mix.

Going to Slide 10. Our updated EPS guide reflects the near-term changes in demand and our production posture, temporary and isolated issues in the supply chain and costs related to acquisitions, integration and divestment activities. We expect these headwinds to be partially offset by a lower effective tax rate in Q4 as a result of tax reorganization activities, driven by upcoming regulatory changes. As I've highlighted, we believe our changed operating and production posture focused on reducing inventories and prioritizing cash flow over volume in reaction to the dynamic operating environment is critical to setting up 2024 outlook where we can maintain and expand operating margins.

Let’s go to Slide 11 and take a quick look at the inorganic moves that we made during the quarter. Here, we summarized the 2 recently announced transaction that align well with our portfolio priorities and enhance the overall quality of Dover’s portfolio through margin growth and reoccurring revenue uplift, all while reducing our exposure to automotive and China. Importantly, we were able to acquire FW Murphy, a lower valuation multiple than our sale of DESTACO and the after-tax proceeds from the DESTACO sale more than pay for FW Murphy, preserving significant balance sheet capacity for additional deployment options.

Slide 12 provides more color on the rationale for the acquisition of FW Murphy by our Precision Components operating unit, which is part of Pumps & Process Solutions segment. FW Murphy brings a highly complementary product offering to our existing position in reciprocating compression industry. FW Murphy’s solutions capitalized on the growing adoption of advanced remote monitoring, control, real-time optimization solutions as customers seek to reduce costs, improve uptime and lower emissions.

In combination with our best-in-class Cook clean technology and our leading position in sealing and valve technology for alternative energy applications, including in hydrogen, the FW Murphy acquisition offers a compelling value proposition into a global industry where we see robust demand from energy transition investments.

The FW Murphy acquisition provides a good segue into our next topic, which is to highlight the recent developments and investment in sustainability-driven markets, starting on Slide 13. There has been plenty of interest around hydrogen as a result of the recent announcement of $7 billion in federal funding for multiple regional hydrogen hubs that are expected to also attract $40 billion in private funding and a roster of blue chip industry participants.
Dover has established a position in hydrogen with the 2021 acquisition of Acme, which supplies flow control components for liquid hydrogen and LIQAL, which offers turnkey hydrogen refueling sites. Additionally, we are organically invested in extending DPCs, gas compression components, to participate in gaseous hydrogen applications. In short, there is no hydrogen economy without compression. We have great relationships with the industrial gas and hydrogen players and aim to participate throughout the whole value chain through transport and storage through end-use in collaboration with equipment OEMs. We are well positioned to capitalize on growth in hydrogen and industry with a high focus on safety and regulatory compliance with high technological requirements for participation.

Moving to Slide 14. The EPA recently finalized its rule under the AIM Act with a deadline for new installation of refrigeration systems to be compliant with lower GWP requirements by January of 2027. We believe this rule is a clear tailwind to our CO2 systems business. And we have had a leading position in the European CO2 market for over a decade where we enjoyed steady double-digit growth trajectory.

We were the early mover in transplanting this technology to the U.S. where we currently enjoy a technological lead and have the largest installed based and broadest differentiated offering. We have proactively expanded our capacity in addition and in anticipation of market growth and have been investing behind a platform-based product strategy to drive standardization, thereby reducing costs for ourselves and our customers, improving product quality and simplifying the sales process.

Our global CO2 business is approximately $200 million in revenue. U.S. market is in the early innings, and we're in our business is on track for 30% growth in 2023 with a strong outlook. We are also excited about our new CO2-based heat pump offerings for industrial and district heating applications. It's early days, but we have an active pipeline of orders.

And finally, on Slide 15 shows our latest views on heat exchangers since it has become a battleground topic. Our heat exchanger business supplies brazed plate technology, which is currently the most sustainable commercialized heat transfer technology for fluids. We have been the clear beneficiary of the sustainability and climate tailwinds across various applications with a lot of attention drawn recently from our participation as a key supplier to hydronic heat pumps. Heat pumps have emerged in recent years as a technology of choice to decarbonize residential heating, which is responsible for a significant portion of global emissions with hydriatic heat pumps as a primary technology to retrofit houses that rely on water-based heating.

Legislative initiatives in European Union and individual countries are driving the conversion of fossil fuel boilers into heat pumps. Recent uncertainties about subsidies in select European countries have weighed on near-term volumes, as I indicated earlier. Our exposure across multiple OEMs and geographies, and as such, they're not over-indexed to any product or customer concentration risk. We remain confident about the long-term growth prospects for heat pumps and our technology.

It's important to note that European residential heat pumps represent only 1/4 of our heat exchanger business. You see several solid growth vectors driven by sustainability tailwinds and continue to share gains from other legacy heat exchanger technologies. We have proactively expanded our capacity as we expect continued robust growth trajectory in heat exchanges, albeit with slightly lower rates in the near term as various dynamics in Europe slow down.

I close my prepared remarks by thanking our global teams for driving our strong financial performance during the quarter. And it's time for Q&A.

**QUESTIONS AND ANSWERS**

**Operator**

(Operator Instructions) Our first question comes from Steve Tusa with JPMorgan.
Charles Stephen Tusa - JPMorgan Chase & Co, Research Division - MD

So I think you were a little more positive in early September than this fourth quarter guidance, understand maybe the world’s changed a little bit since then. Maybe you could just discuss that. But then just looking ahead, thinking about perhaps a more cautious view of the world for next year, what’s kind of a low-end assumption for next year when it comes to organic margins, just to kind of level set us on a case where perhaps the orders don’t recouple as strongly to the trend lines or the trend lines are a little bit weaker? Like in your macro view, what is a more cautious outlook for next year bring for Dover? Because you’ve been talking about growth there as things recouple the trend. It seems like that would have changed over the last month or so.

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

Okay. That’s a lot to take on this. Steve, let’s give it a try. Look, I think if I -- if we look at our forecast for the year, we were just wrong about biopharma. I mean, we were getting indications from our customers that there was going to be some nascent recovery. We actually did see some order upticks, but quite frankly, it just never turned into much. So that’s a little bit different than we were back in September. I think we just have to throw in the towel on biopharma demand and it gets pushed to 2024.

We didn’t expect in terms of market dynamics was this UAW on trucks, right? We thought it would stay limited into the car sector. And unfortunately, what we were betting on is being able to ship quite heavily out of ESG in Q4. We’ll actually have a good quarter in Q4, but it’s not going to be as robust in our plans.

I think I mentioned on the heat exchangers, that was a little bit of a abrupt reversal and really didn’t happen until almost the end of Q3. So up until about 30 days ago, everything looked good there. And I think that we’ve got a little bit of a pivot as what we understand is there’s a lot of finished goods in the supply chain that need to be reduced from there.

So at the end of the day, I think it slowed some and -- which leads into the next question. And the next question, our positioning now is to drive for cash, because I think that the way we’re going to be able to protect margins into 2024 is not to be long inventory. We had a lot of discussions around here about incentivizing revenue in ’24 driving revenue, but then you start touching on things like price and you start touching on things like payment terms, and we’re not going there.

I mean I think that the strategy that we have to is to adapt quickly and efficiently to the market demand, bring down our inventory with the hope of -- with the strategy of protecting margin into next year. And I think if you look at how we’ve handled demand this year, it’s exactly what we’ve done at the end of the day. I mean, we talked about it before. What we had seen over the previous 2 years was not a lot of unitary demand. You saw a lot of pricing going into the system. So we came into this year saying, there’s probably going to be less price and some unitary demand, but the important -- and I think that we’ve done that in terms of managing -- which is reflected in our margins year-to-date, is managing not getting oversupply and over our SKUs a little bit in terms of inventory and that we’re going to take that on for next year.

Do you want me to make a call on the market next year? I think we’re going to have to wait on that. Clearly, there’s a lot of headwinds in the system. I don’t want to get on a personal soapbox, but the amount of liquidity that’s being withdrawn is going to show up somewhere. And this notion that we’re all going to wait on the government to bail us out, because there’s this wave of government spending coming, I find that a problematic strategy. So I think it all is going to be triggered by monetary policy between now and the end of the year, which is going to allow for us to predict growth into next year.

What I can tell you is if we do what we’re planning on doing in Q4, we will not be long inventory, and we’re not going to get into a situation where if there are kind of top line headwinds that we’re going to have to start playing price to drive growth.

Charles Stephen Tusa - JPMorgan Chase & Co, Research Division - MD

So like should we just think about flat as a starting point for next year?
Richard Joseph Tobin - Dover Corporation - President, CEO & Director

No, I don’t think so. I think that we’re ahead of the curve. Remember, we’re a component supplier into end market industries, right? So we’re first at the end of the day. So I think that if we get this right, we’ve got top line growth next year, even in a pretty benign kind of macro environment, I think that we can drive growth. And I think that’s part of the reason that we covered some of those growth vectors in terms of our investment at the end of the presentation.

Operator

The next question comes from Jeff Sprague with Vertical Research Partners.

Jeffrey Todd Sprague - Vertical Research Partners, LLC - Founder & Managing Partner

Rich, maybe a question on restructuring and thinking fueling in particular. I think you had a lot of restructuring planned there for Q4, but it looks like you’re guiding margins kind of flat, I guess, on a year-over-year basis. Could you speak to that? Maybe it’s some of the absorption issues you’re talking about on inventory, but love some more color on the margin trajectory there.

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

Sure. I think if you go back and look at the script, basically, what it says is the restructuring that we took is going to protect margins into Q4, because we actually have a poor mix forecasted for Q4 because where we’ve been seeing the headwinds in Fueling Solutions is in the below-ground portion of the segment, and that is highly accretive to margins. We’re basically -- you heard me answer Steve’s question there, we’re taking the position of let’s allow inventory to be draw down even we would argue at this point, below even normal levels between now and the end of the year and protect production performance into next year. So the restructuring benefit -- the restructuring that we’ve done is actually protecting margins into Q4.

Jeffrey Todd Sprague - Vertical Research Partners, LLC - Founder & Managing Partner

And on these questions of just kind of what’s at the customer level, right, whether it was biopharma earlier this year, heat pumps, maybe now, some other pockets, how would you kind of square up your visibility and kind of comfortable on understanding what the right level of inventory is or when the customer demand equation might turn a little bit?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

Yes. I think we’re getting a lot better at it. At the end of the day, where we sell through distribution, we have visibility, right, because we’ve just got a material position within distribution, so we can see pretty much stocking levels. At the OEM level, it becomes a lot more difficult. At the end of the day, we’re relying on the OEMs to basically tell us their own position.

So let’s take heat exchangers. Up until 45 days ago, it was still a demand capacity deficit of give us everything you’ve got and then all of a sudden, for reasons that I tried to cover, the markets come to a halt, because there’s a recognition of the seemingly is a lot of finished goods in the chain now that need to be bled off. So like I said, from -- if it’s distribution, I think that we’ve got a pretty good handle on it. When it’s OEM, we just got to take the signals from them.

Jeffrey Todd Sprague - Vertical Research Partners, LLC - Founder & Managing Partner

I’m sorry, just a quick one for Brad. Does the tax rate bounce back to 20-something next year? Or what should we expect going forward?
Brad M. Cerepak - Dover Corporation - Senior VP & CFO

Yes, Jeff, the things we're seeing here in Q3 and into Q4 on taxes, will not carry into next year. So said differently, I think our '24 tax rate is going to be much like we saw earlier in this year when we gave guidance, somewhere in that 20% to 22% rate.

Operator

The next question comes from Andrew Obin with Bank of America.

David Emerson Ridley-Lane - BofA Securities, Research Division - VP

This is David Ridley-Lane on for Andrew Obin. Rich, how would you characterize kind of the excess backlog at this point in time, and how that kind of interplays into the revenue you’ll see versus kind of the bookings trends that you need?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

I don't think that we have excess backlog anymore. I mean, I think that we're -- by the end of the year, we will have drawn down our longer cycle backlog, particularly in Belvac and Maag, which drove a lot of it. I think it will end up being a little bit higher than kind of on average in terms of its aggregate, if you go back and look over the last 5 years, but that is more related to portfolio -- general portfolio mix as opposed to anything else.

So like I said, at the end of the year, we think that we'll be in balance between our inventory and our -- either the customer distribution inventory, I would expect the long-cycle business backlogs to be done, that reduction to be done by the end of the year.

David Emerson Ridley-Lane - BofA Securities, Research Division - VP

Got it. And then I know it's tough to ask about bookings, but do you see bookings sequentially increasing in the fourth quarter then?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

I got to go back and take a look. I mean, I would say flat. If I think about where bookings are coming from, we got a lot in ESG at high dollar value, because quite frankly, we're booking well into '24 in that particular business just because of supply constraints. Flat, I would call it right now. I think that there's an overall caution with the macro, everybody recognizes that lead times have been vastly reduced. So I think that there's going to be a lot of hurry for bookings in Q4, but we would expect pretty large acceleration in Q1 if we got...

Operator

The next question comes from Mike Halloran with Baird.

Michael Patrick Halloran - Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research & Senior Research Analyst

Two here. So first, on the inventory side, you're obviously bringing your inventory down a fair amount pretty aggressively, more so than what we're hearing elsewhere. Do you have the same sense of urgency in the channel when you look at your channel partners? Or do you think they're lagging the pace of your inventory drawdown?
Richard Joseph Tobin - Dover Corporation - President, CEO & Director

No. I think that our channel partners are, in certain cases, below normal holding pattern. And that is because of the cost of carry with interest rates. So if you think about a typical distributor that’s got $100 million of inventory, a working capital loan that they would have been able to have 18 months ago was probably 2% or 3%, they’re probably paying 9% now, right? So there’s a dynamic now because of higher interest rates of everybody trying to liquidate working capital because of the cost of that working capital, us included, by the way.

And we’re in a little bit of a standoff in certain end markets where we would argue that inventories are down too low, but we are not going to incentivize revenue into the system either through price or through terms. We’re just going to sit tight and we’ll cut our own production into Q4, because that’s just harvesting demand that’s in ’24 into ’23.

Michael Patrick Halloran - Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research & Senior Research Analyst

So the comment that you made to the previous question about order or having a better chance to turn positive in the first quarter, I’m guessing part of it is the comments you just made that inventory flush through the channel, essentially normalizes by year-end, and you should have at least normal throughput, if not a little bit more, given where inventory levels are in certain channels.

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

That’s correct. I mean, if you look at the top line revenue trajectory in some of our businesses, you have to take destocking into it. That’s not a reflection of end market demand. It’s end market demand minus destocking.

Michael Patrick Halloran - Robert W. Baird & Co. Incorporated, Research Division - Associate Director of Research & Senior Research Analyst

Great. And then on the DPPS side, maybe just kind of parse out the moving pieces there. Obviously, you have the continued destock on the biopharm piece, creating some pretty easy comps in the next year, but a lot of your other pieces are a little bit more IP sensitive. So maybe just talk about some of the moving pieces you’re seeing on that side?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

Well, I think that overall, it’s underestimated, the amount of profit loss that we’ve had on the biopharma reduction. To the extent that we’re clocking at record margins in the quarter, while eating this pretty bad sandwich here, I think that -- quite frankly, I think we’re pretty proud of. So to the extent that it’s pushed into ’24, at the end of the day, the comps get pretty damn easy once we get into Q1 of next year.

The balance of the underlying business, Precision Components, where we basically bought FW Murphy into, look, we’re behind energy transition. We’re betting on gas in total LNG hydrogen, you name it. Order rates there, we expect to be really good. I think Maag on plastics and polymers, we’ve driven down a lot of that backlog. That’s probably the one business that’s probably going to be weaker next year, but I think it gets completely offset by DPC and by FW Murphy and some amount of bio.

Operator

The next question comes from Andrew Kaplowitz with Citigroup.

Andrew Alec Kaplowitz - Citigroup Inc., Research Division - MD and U.S. Industrial Sector Head

Rich, you’ve talked about being proactive regarding cost out. But if economics can stay somewhat difficult, what kind of opportunities do you have to deliver the kind of margins you just delivered in Q3? And then I think you were fearful at the beginning of the year that pricing in industrials
might erode a bit. Have you seen any erosion or do you expect any erosion in your markets? Or would you still expect resilient price cost moving forward?

**Richard Joseph Tobin** - Dover Corporation - President, CEO & Director

We're always working on efficiency and structural cost takeout at the end of day. So that's just part and parcel to the business model here. Look, in a dire demand environment, if I point back to how we performed during the COVID period, we've got the ability to flex the cost structure, we don't want to, other than kind of productivity and efficiency driven not from a demand point of view.

As it relates to pricing, look, I think there was a comment in the script, if you go back and look, is that we fundamentally believe that inventory position is going to be incredibly important as it relates to pricing as it goes into '24. And that's why we're taking a little bit of hard medicine here between now and the end of the year of not to incentivize demand through pricing action, right? We've done a lot of hard work of moving the margins up here, and we're keeping these margins.

**Andrew Alec Kaplowitz** - Citigroup Inc., Research Division - MD and U.S. Industrial Sector Head

Helpful, Rich. And then maybe just a little more color into the puts and takes you're seeing in DCST. You mentioned the slowdown in the heat exchangers, but the strength in CO2 systems, you mentioned as well, and you did deliver strong margin. Do you still see DCST as a growth segment for you in '24? And how would you assess margin potential from here given what you just reported in Q3?

**Richard Joseph Tobin** - Dover Corporation - President, CEO & Director

Look, I think that -- I think the heat exchanger is temporal, right? I mean, we went through this incredible amount of demand. I don't know if we were clocking up until a month ago, but it was very high demand that we had there. I think this is just a little bit of an inventory clearing things. So we expect growth out of the exchanger business next year. I think that we did our highest margin quarter in refrigeration in the last 5 years here. We don't think that, that's -- we're going to give back there. Now just recall, though, that Q4, we have to take production down due to seasonality there, all right? So that has some amount of impact on margins.

But the trajectory on refrigeration, coupled with CO2, which is margin accretive, we would expect margins to increase there next year. Clearly, we're going to -- that will likely offset the negative input from Belvac, which we expect will run off its backlog next year and have a little bit of a down year in 2024.

**Operator**

The next question comes from Joe Ritchie with Goldman Sachs.

**Joseph Alfred Ritchie** - Goldman Sachs Group, Inc., Research Division - VP & Lead Multi-Industry Analyst

Just a few quick follow-ups on just the inventory dynamics because, I mean, Rich, you've been doing this for a while. It typically -- based on what we've seen, it typically takes longer than a quarter to normalize inventory. And so just any color on your confidence on being able to get inventory where you need it to be by the end of the year? Or is there a good likelihood that some of this kind of spills into 2024?
Richard Joseph Tobin - Dover Corporation - President, CEO & Director

Well, I mean, when we’re talking about total inventory, we’re talking about our own inventory, which we’re in control of, which is reflected in the cash flow that we’re signing up for, right? That takes working capital liquidation, a big chunk of that is inventory. I think if you look at the $600 million of free cash flow during the quarter, a material chunk of that was our own inventory reduction.

When we’re talking about channel inventory, like I said before, we’re -- we’ve been -- the channel inventory in a lot of our end markets has been coming down progressively over the year. And now we’re adopting a posture between now and the end of the year in certain businesses to allow that inventory to clear rather than try to push revenue into either channel inventory or OEM inventory and because the only way you can do that is to start modifying commercial conditions, and we’re not doing that.

So should it clear, we believe that we’re on the front foot here, and so I think we’ll be in balance in kind of most of our end markets by the end of the year. And then it just becomes a question of what does growth look like next year and how much confidence there is in the end markets of how much that channel and how quickly they build it back. But we feel good about the trajectory we’re on. So that -- it’s an end-of-the-year phenomenon based on current demand rates.

Joseph Alfred Ritchie - Goldman Sachs Group, Inc., Research Division - VP & Lead Multi-Industry Analyst

Got it. Okay. That’s helpful. And then I guess just a real quick one on just 4Q in DPPS. So I think you called out flat growth in the segment. So sequentially, revenue is down a little bit. I’m curious just from a margin standpoint, similar revenues -- similar margins for 3Q? How do you think about the margins in 4Q for DPPS?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

They’re either -- it will be immaterial up or down, right, subject to mix.

Operator

The next question comes from Brett Linzey, Mizuho.

Brett Logan Linzey - Mizuho Securities USA LLC, Research Division - Executive Director

I just wanted to ask a question on the portfolio. I guess as you consider additional pruning, is there a way to maybe quantify what percent of revenue could be under review? And certainly understand M&A is episodic, but are you seeking to find comparable sized acquisitions to offset? Or how should we think about this portfolio shuffle?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

The portfolio -- the whole portfolio is under review all the time. Look, no. Look, we don’t go around and say, we’ve got a business that’s got $200 million revenue, let’s go buy $100 million to $200 million revenue. No one can orchestrate that. But I think that we’ve gone over, Brett, a lot about where our priorities are to the extent that we could make a change to our portfolio that we did without touching our balance sheet, I think, is a positive. So to the extent that we could do that repeatedly, that would be great, but that is subject to a lot of timing differences both in and out at the end of the day.

But just as an overall comment, what we did this quarter in M&A is what we would like to do progressively every year.
Brett Logan Linzey - Mizuho Securities USA LLC, Research Division - Executive Director

Got it. Makes sense. Just shifting back to heat exchangers and the destock in Europe and Asia. I guess, does this slow the rollout of some of those capacity additions or change the way you're at least thinking about the near term from a capacity standpoint? And then what is your level of visibility there in terms of these imbalances that have maybe skewed more negatively here?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

No, I think the capacity is coming on sequentially. These are highly automated plants. So it’s not like we’ve got to ramp employees. It’s -- they’re almost blackout plants at the end of the day. So we needed the standing capacity. Remember, heat exchangers is 40% of the revenue. So I get -- it’s getting a lot of headlines, and that’s why we wanted to address it. Our visibility is, as I mentioned, is not great because it’s an OEM sale mostly for us. So up and to the point where they decide they want to slow down, that’s what we find out. And the slowdown that we’ve been called out for the balance of the year manifested itself over the last 45 days or so.

So are we worried about the capacity investment? Absolutely not. We think that the technology is fundamental. It’s going to grow over time. There’s been a massive amount of capacity in heat pumps that’s been announced. It always seems a little bit implausible. So I think at the end of the day, the market reset is going to be on the finished goods, not so much on the consumption of the heat exchangers.

Operator

The next question comes from Julian Mitchell with Barclays.

Julian C.H. Mitchell - Barclays Bank PLC, Research Division - Research Analyst

One element I just wanted to circle back to in context of the inventory discussion is around the free cash flow margin guide. So I think that it’s very high still for this year, but maybe move down a little bit and that’s despite the good progress on the inventory liquidation that you cited in Q3. So maybe just any sort of color around the moving parts inside free cash flow, and it has been very volatile. So any sort of thoughts on maybe next 12 months as it’s more sort of normalized?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

Well, it’s been volatile only because of the amount of demand that was there. And to meet that demand, you had to basically an expansion of everybody’s balance sheet from an inventory point of view. I think that when we put out the guidance for this year, we basically said now that we’re in a more normalized market that we were going to bring inventories down. I think we’re making really good progress on raw materials. I think by cutting production in Q4, we should clear WIP and finished goods, then it’s all about receivables from here to the end of the year.

Julian C.H. Mitchell - Barclays Bank PLC, Research Division - Research Analyst

I see. And so receivables was kind of the main delta on the change in the free cash margin guide?

Brad M. Cerepak - Dover Corporation - Senior VP & CFO

Well, it’s part of it. But as we went -- if you go back and look at what our commentary has been over the course of the year, we’ve indicated it’s tough to bring inventories down, but we did that in Q3. We see that continuing into Q4. As we look back, and the actual good performance in Q3, receivables, given the timing of sales, actually built in the quarter a bit. So that liquidation is due to come here in the fourth quarter.
And I think we'll see very robust cash flow again, based on the commentary that we already provided that fourth quarter is always seasonally strong. But I think given the actions we're taking, it will be even more robust, in line with our guide.

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

Yes. Between cash flow and the proceeds of the disposal, which we'll receive in Q1, we're in a very healthy cash position.

Julian C.H. Mitchell - Barclays Bank PLC, Research Division - Research Analyst

That makes sense. And maybe just to follow up on the question around the sort of the sales outlook. So I think it's very clear and the right thing to do that you're sort of under selling into the channel, if you like, short-term, to make sure channel partners have low inventories entering the new year. When you sort of take that take comment plus the improvement in some orders figures you've seen recently, does that make you sort of confident around the revenue growth outlook despite what the backlog has done? And so we should sort of take the low inventories in the channel plus the orders movement, that's a better determinant of sort of sales into early next year than perhaps what the backlog has been doing recently?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

Yes. I mean at the end of the day, everything that's in our control for 2024, I think that we're taking the right move. So we discussed managing channel, right, from an inventory point of view. The reason that we highlighted some of the investments, we think that those are growth vectors that those businesses are going to grow despite the macro, right, that they're not subject to kind of general sentiment at the end of the day, or interest rates or anything else just because they've got a demand there.

So yes, I mean, look, we're -- knock wood, we're feeling positive about our setup going into 2024 based on how we've managed and we'll continue to manage 2023.

Operator

The next question comes from Deane Dray with RBC Capital Markets.

Deane Michael Dray - RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst

I was hoping to get some color on the retail fueling. It just sounds like there was a bit of a disconnect between below ground and above ground. Below ground seem to be feeling the effects of higher rates and maybe some destock, but you weren't seeing that above the ground. But just can you square those, please?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

Sure. We had -- in 2022, we had a great year in below ground and a bad year in above ground. So if you think about kind of the time it takes to build sites or refurbishment sites, you had kind of capacity that got built and then they finished the job on the top this year. Below ground now is in a bit of a headwind because of the fact that if you think about like a retailer. A retailer is going to spec in the product that they want at a fueling site and then going to go contract the installation.

And part of the problem is it's no longer labor anymore, and it's no longer a product availability. It's the fact that those contractors need working capital loans in order to do these projects and the cost of those loans now is probably quintupled over the last year or so. It was very nice for everybody to be talking about 5%. 5% is a baseline. You're a contractor, you need a working capital loan, you're paying 9 or 10. And so that is putting a little bit of a drag in terms of getting that work done, number one.
And number two, just a general comment, as I gave the example before, there's that -- a lot of that underground business, at least the recurring revenue portion of it is sold through distribution, the carrying cost of that inventory has gone up quite a bit, and you basically see almost an over liquidation of inventory in the chain, because they know that our lead times are down low, so they're taking their inventory down because they don't want to pay the carrying cost. At some point, that's got to give, and we're not incentivizing through price or terms to push that inventory back into the system. We'll deal with that on the come when we get into 2024.

Deane Michael Dray - RBC Capital Markets, Research Division - MD of Multi-Industry & Electrical Equipment & Analyst

All right. That's really helpful. And then just a follow-up on the geographies. Just the idea, what were the surprises and maybe you're seeing some of the macro begin to be felt on the U.S. side was down 7%? But -- what surprised you there?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

I think it's more and more -- look, no one came into this year thinking that Europe was going to be robust. It hasn't been. I think that CO2 systems and heat exchangers are running counter to that argument. CO2 is actually performing quite well. The heat exchanger issue, like I said, up until 45 days ago, you couldn't make enough of them to supply heat pump demand and that just came to quite a halt here, I think, in a recognition that there's too much inventory in the chain.

We were not very hopeful about China, and China has been poor. And I think in the U.S., it's just the general -- what I just answered, I gave you the example a second ago. In the U.S., you can't raise rates at the rate we're doing and not to have knock-on effects in terms of the carrying cost and that's what we're seeing now.

Operator

Our final question comes from Nigel Coe with Wolfe Research.

Nigel Edward Coe - Wolfe Research, LLC - MD & Senior Research Analyst

So going back to the noncore kind of the portfolio review, I mean, obviously, there's a part of game about trying to guess, which assets might not meet the cuts going forward. But DESTACO wasn't one of those assets. I think already seen as potentially noncore. So I'm just curious given the decent growth, obviously, very good margins, what was it that led that asset to being sold?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

I think that the growth was okay, at least in my tenure here. The end market exposure, both from -- the end market exposure and the geographical exposure, we did not find attractive.

Nigel Edward Coe - Wolfe Research, LLC - MD & Senior Research Analyst

Too much Europe, I assume?

Richard Joseph Tobin - Dover Corporation - President, CEO & Director

Too much auto and too much Asia.
Too much Asia.

Too much China, yes.

Okay. And then just on buybacks, you did an ASR last year. You’ve got a fair amount of balancing flexibility if you get your free cash flow forecast with the sale as well. I mean, any thoughts on buybacks at these levels?

I mean, look, buying back our stock at these levels has become very attractive. I think that we’ve got a lot of moving parts right here in terms of delivering on the fourth quarter and the cash flow. And then we’ve got an outbound on the acquisition and an inbound on the disposal. After all that is settled, we’ll clearly be in a very healthy balance sheet position. And I’m sure that capital return discussion will come to the forefront.

Thank you. That concludes our question-and-answer period and Dover’s Third Quarter 2023 Earnings Conference Call. You may disconnect your line at this time, and have a wonderful day.