



Federal Signal Corporation
Second Quarter Earnings Conference Call
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C O R P O R A T E P A R T I C I P A N T S

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P R E S E N T A T I O N

Operator

Welcome to the Federal Signal Corporation Second Quarter Earnings Conference Call.

The conference is being recorded.

I would now like to turn the conference over to Ian Hudson, Chief Financial Officer. Please go ahead.

Ian Hudson

Good morning, and welcome to Federal Signal's Second Quarter Conference Call. I'm Ian Hudson, the Company's Chief Financial Officer. Also with me on the call today is Jennifer Sherman, our President and Chief Executive Officer.

We will refer to some presentation slides today as well as to the earnings news release which we issued this morning. The slides can be followed online by going to our website, federalsignal.com, clicking on the Investor Call icon and signing into the webcast. We have also posted the slide presentation and the earnings release under the Investor tab on our website.

Before we begin, I'd like to remind you that some of our comments made today may contain forward-looking statements that are subject to the Safe Harbor language found in today's news release and in Federal Signal's filings with the Securities and Exchange Commission. These documents are available on our website.

Our presentation also contains some measures that are not in accordance with U.S. generally accepted accounting principles. In our earnings release and filings, we reconcile these non-GAAP measures to GAAP measures. In addition, we will file our Form 10-Q later today.

I'm going to begin today by providing some detail on our second quarter results before turning the call over to Jennifer to provide her perspective on our performance, market conditions and thoughts on the rest of the year. After our prepared comments, Jennifer and I will address your questions.

Our consolidated second quarter financial results are provided in today's earnings release.

In summary, we delivered another outstanding quarter with operating results exceeding our expectations despite dramatic increases in commodity costs and ongoing supply chain disruption, including factors linked to the global shortage in semiconductors.

As a reminder, in the prior year quarter, we also took several cost saving actions in response to the uncertainty created by the pandemic, which reduced our costs in Q2 last year by approximately \$14 million. While most of these savings were either temporary cost reductions or volume related, some were more permanent actions. In Q2 this year, the return of many of these costs represented a year-over-year expense headwind of approximately \$5 million.

Consolidated net sales for the quarter were \$335 million, up \$65 million or 24% compared to last year.

Consolidated operating income for the quarter was \$38.5 million, up \$7.2 million or 23% compared to last year.

Consolidated Adjusted EBITDA for the quarter was \$51.9 million, up \$6.5 million or 14% compared to last year. That translates to a margin of 15.5% in Q2 this year compared to 16.8% last year.

Net income for the quarter was \$29.7 million, up from \$21.4 million last year. That equates to GAAP EPS for the quarter of \$0.48 per share, up 37% from \$0.35 per share last year.

On an adjusted basis, EPS for the quarter was \$0.50 per share, an improvement of 19% compared to \$0.42 per share last year.

Order intake for the quarter was again outstanding, with orders of \$361 million representing an increase of \$159 million or 79% compared to Q2 last year. Consolidated backlog at the end of the quarter set a new Company record at \$437 million. That represents an increase of \$104 million or 31% compared to Q2 last year and an increase of \$133 million or 44% from the end of last year.

In terms of our group results, ESG's net sales for the quarter were \$281 million, up \$67 million or 31% compared to last year.

ESG's operating income for the quarter was \$38.5 million, up \$9.9 million or 35% compared to last year.

ESG's Adjusted EBITDA for the quarter was \$50.6 million, up \$9.7 million or 24% compared to last year. That translates to an Adjusted EBITDA margin for the quarter of 18% at the high end of our current target range but down a 110 basis points compared to last year.

ESG reported total orders of \$300 million in Q2 this year, an improvement of \$142 million or 90% compared to last year.

SSG's net sales for the quarter was \$53 million compared to \$56 million in Q2 last year, which included a large fleet sale of public safety equipment to a customer in Europe.

SSG's operating income for the quarter was \$7.8 million compared to \$10.4 million last year.

SSG's Adjusted EBITDA for the quarter was \$8.7 million compared to \$11.7 million last year. Adjusted EBITDA margin for the quarter was 16.3% compared to a record margin of 20.9% in Q2 last year, which included favorable sales mix and lower operating expenses.

SSG's orders for the quarter were \$61 million, up \$17 million or 39% compared to last year, with most of the improvement resulting from higher demand for public safety equipment in both domestic and international markets.

Corporate operating expenses for the quarter were \$7.8 million compared to \$7.7 million last year.

Turning now to the consolidated income statement, where the increase in sales contributed to an \$11.3 million improvement in gross profit.

Consolidated gross margin for the quarter was 24.4% compared to 26% last year.

As a percentage of sales, our selling, engineering, general and administrative expenses for the quarter were down a hundred basis points from Q2 last year.

Other items affecting the quarterly results include a \$1.3 million reduction in restructuring charges, a \$2.3 million decrease in other expense and a \$700,000 reduction in interest expense.

Tax expense for the quarter increased by \$1.9 million, largely due to the increase in pretax income levels, partially offset by higher excess tax benefits from stock compensation activity. Including the effects of these higher tax benefits, our effective tax rate for the quarter was 21.2% compared with 22.2% last year. At this time, we expect our full year effective tax rate to be approximately 23%.

On an overall GAAP basis, we therefore earned \$0.48 per share in Q2 this year compared with \$0.35 per share in Q2 last year. To facilitate earnings comparisons, we typically adjust our GAAP earnings per share for unusual items recorded in the current or prior year quarters.

In the current year quarter, we made adjustments to GAAP earnings per share to exclude acquisition-related expenses, pension-related charges, coronavirus-related expenses and purchase accounting expense effects. On this basis, our adjusted earnings for the quarter were \$0.50 per share compared with \$0.42 per share last year.

Looking now at cash flow where we generated \$13 million of cash from operations during the quarter, bringing the year-to-date operating cash generation to \$39 million. During the quarter, we elected to accelerate the timing of certain tax payments to preserve tax planning flexibility in the event of a possible increase in U.S. corporate tax rate. With this approach, we expect to see lower tax payments in the third and fourth quarters, while at the same time creating the potential for future tax savings.

In addition, in Q2 last year, our cash flow benefited from certain deferrals that were permitted under the CARES Act. We have also increased investments in our Rental fleet, given the improving utilization levels we are experiencing.

For the rest of the year, we are expecting strong cash flow generation, and we continue to target cash conversion of approximately 100% on a net income basis. We ended the quarter with \$169 million of net debt and availability under our credit facility of \$268 million. Our current net debt leverage remains low. With our financial positioning rate remaining strong, we have significant flexibility to pursue strategic acquisitions, invest in organic growth initiatives and return cash to stockholders through dividends and opportunistic share repurchases.

On that note, we paid dividends of \$5.5 million during the quarter, reflecting a dividend of \$0.09 per share, and we recently announced a similar dividend for the third quarter.

That concludes my comments, and I would now like to turn the call over to Jennifer.

Jennifer Sherman

Thank you, Ian.

I'd like to start my comments with a quick update on a subject that we've been talking about for a long time: an infrastructure bill. The reports from late yesterday were encouraging. It finally appears that infrastructure legislation is likely. Some components reported to be part of the deal, which includes a total of \$550 billion in new federal investment in U.S. infrastructure include \$110 billion for roads, \$73 billion for power infrastructure, \$65 billion to expand broadband access, \$55 billion for water infrastructure, \$46 billion for environmental resiliency, and \$11 billion for transportation safety. We are optimistic that an infrastructure package in these areas would provide funding that would support the use of the majority of our product offerings, including equipment sales and rentals of dump trucks and trailers, safe digging trucks, road marking equipment, sewer cleaners and street sweepers.

Turning now to our performance in the quarter. Our teams again delivered impressive results with meaningful growth in both the top and bottom line while achieving Adjusted EBITDA margin towards the high end of our target range despite widespread supply chain disruptions and an unprecedented commodity cost environment.

Top-line growth was largely across the board, with particular strength in the sales of dump truck bodies and trailers, which were up around \$15 million from Q2 last year. Thanks to the proactive action of our teams, we were also able to respond to customer demand by delivering more safe digging trucks and sewer cleaners than we had originally anticipated.

Over the last several years, we have successfully diversified our revenue streams and end market exposures through a combination of organic growth initiatives in M&A, and that helped us to partially mitigate the impact of these factors during the second quarter.

Another area of notable strength during the second quarter was in our Aftermarkets business. While the second quarter is typically a seasonally strong period for Aftermarkets, we originally had some concerns entering the quarter that rental activity in Canada would be adversely impacted by various shutdown measures taken in response to the pandemic. Thankfully, vaccination levels are increasing quickly in Canada and restrictions are easing. Rental activity and demand for used equipment was higher-than-expected, with rental utilization in Canada exceeding our targets and returning to pre pandemic levels.

Rental utilization in the U.S. is also improving. For example, rental utilization of our Jetstream water blasting equipment exceeded the levels we saw in 2019. The improved utilization followed a strong spring shutdown cleaning season, which has historically been a leading indicator of industrial end market recovery.

In June, with a combination of high rental utilization and strong used equipment sales, our JJE Rental business reported the highest monthly revenue in its history. Those favorable trends have continued into July as well. Overall, our Aftermarket revenues in Q2 this year were up \$26 million, or 46% year-over-year, growing to represent a higher share of ESG revenues for the quarter at around 30%. That shift in mix helped to partially mitigate the impact of higher commodity costs and production-related inefficiencies associated with supply chain disruption, helping ESG to deliver an Adjusted EBITDA margin at the high end of the current range.

As we mentioned on our last call, following the suspension of chassis production at one of our suppliers, we made the decision to temporarily shut down production at our facility in Streator, Illinois, for a two-week period around the Fourth of July holiday. The team worked tirelessly to mitigate the impact of this short-term disruption by effectively managing production schedules to meet record customer demand. With the expansion of our Streator facility now complete, our production in May approached the record levels we experienced in 2019, helping us to deliver more units than anticipated ahead of the shutdown despite the inefficiencies associated with supply chain constraints.

Like many companies, we also experienced increased freight charges as we expedited the supply of certain components and higher commodity costs. As they have done in the past, our Procurement teams took several proactive measures, including securing availability of certain steel and locking in pricing based on forecasted needs. We also work diligently to mitigate the impacts by implementing several price increases and surcharges. Despite these actions and with demand being significantly higher than we had expected, we experienced an unfavorable price cost year-over-year headwind of approximately \$3 million during the quarter, mostly within our Dump Truck and Trailer business.

In Q2, we also realized the benefits from strategic investments we had made in prior quarters in building additional stock units and procuring additional chassis so that we had greater flexibility to meet customers' needs. These investments have enabled us to deliver on customer expectations, in some cases supplying chassis when they were unable to procure the chassis, which resulted in a higher concentration of low-margin chassis that we supplied as opposed to customer-supplied chassis.

Despite this unfavorable impact on margins this quarter, we are playing the long game by prioritizing customer deliveries and satisfaction. We continue to believe that in these challenging times, the strong will get stronger, and we've seen this happen. While the current widespread macroeconomic factors could have some impact on our margins in the near term, we are taking this opportunity to try to leverage our competitive advantage to gain market share.

Demand for our product offerings continues to be strong, as demonstrated by our outstanding second quarter order intake of \$361 million. Our teams are energized as we enter the second half of the year with a record backlog, reflecting strength across our end markets and continued confidence in a post pandemic recovery. This sentiment has been widely shared by our customers and dealer partners and seems to be further solidified by recent economic stimulants.

As a reminder, the American Rescue Plan COVID relief package passed earlier this year included \$1.9 trillion of economic stimulus, with approximately \$350 billion earmarked for state, local and territorial governments for a variety of purposes, including the maintenance of essential infrastructure, such as sewer systems and streets.

In May, the first \$175 billion tranche started to be distributed by the Treasury Department, with a second tranche expected in 2022. Recent market planning sessions with our dealer channel highlighted early indications that the first tranche was starting to be allocated to essential service purchases. As a provider of equipment used for these essential services like sewer cleaning and street sweeping, we stand to benefit from additional aid that may be provided to state and local sources for these purposes.

On the municipal side, demand for sewer cleaners and street sweepers remains high. Within our SSG Public Safety businesses, we are seeing benefits from new product introductions and our ability to meet customer demand. We believe we are in a stronger position than many of our competitors and are gaining share. We've also seen a notable uptick in our industrial end markets, with improved orders for our Guzzler and Jetstream products. Orders within our Dump Body and Trailer business in Q2 this year were more than double last year's orders, with growth across all end markets resulting in a record backlog. This is another area where we believe we are gaining share that will position us well for the future.

While our backlog is at a record high, there are a few headwinds that we, like many other industrial companies, will continue to monitor closely during the second half of the year.

The first factor that many of you will be aware of is the continued impact of the global semiconductor shortage, which is causing significant disruption regarding chassis delivery. This situation changes weekly. Because we do not rely on any one single chassis manufacturer and with the proactive actions we took, we have so far been able to pivot to alternative suppliers to minimize the financial impact. However, the situation remains fluid and ongoing chassis delivery delays are almost universal due to component shortages. Beyond chassis, we are experiencing other supply chain tightness, ranging from reduced availability of paint epoxy within our Road Marking business, to cylinders that are used in certain trucks. So far this year, we've been able to successfully navigate through the difficulty, but it remains a challenging situation.

The second factor relates to the current commodity cost environment. We currently expect the price-cost impact in Q3 to be in the same neighborhood as we saw this quarter. But with the pricing actions we have taken, we are expecting to see improvement beginning in the fourth quarter with more price realization expected as our backlog turns.

On a more positive note, we continue to have relatively good access to labor at many of our facilities, which has recently been an issue for many companies. Our ongoing commitment to environmental, social and governance initiatives is positioning us well in the communities in which we operate and is a differentiating factor in our ability to attract labor at many of our facilities. We are still getting multiple quality applicants for open positions at our largest facility, and certain of our TBEI locations are starting to see traction from its recently introduced School of Weld program. Overall, our access to labor remains good.

Further, our company-wide efforts to raise awareness about vaccines, assist eligible employees in gaining access to vaccines and encourage participation levels are paying off with a company-wide vaccination rate of approximately 50%. Domestically, about two-thirds of our businesses have achieved vaccination rates that are higher than the relevant state average. We have also had notable improvements in Canada during the second quarter, with greater vaccine accessibility. COVID related disruptions have diminished as vaccination (audio interference). And most importantly, 100% of our employees that have been affected by COVID have since recovered.

I now want to take a few minutes to provide an update on some of our strategic growth initiatives. On the organic front, I've already touched on the success of our Aftermarket initiative. We also remain bullish about Safe Digging prospects. And with noted industrial end market recoveries and infrastructure spend optimism throughout the channels, we are confident Safe Digging trends will continue to improve. Our TRUVAC safe digging product line portfolio includes a complete range of truck-mounted safe digging equipment which can be used in a broad range of applications, including expanded application in utility markets.

As an example, one of the nation's largest utility companies recently announced plans to bury 10,000 miles of its power lines to reduce the risk of California wildfires. Use of safe digging technologies significantly minimizes chances of damaging underground infrastructure during the digging process and provides significant environmental benefits by minimizing damage to tree roots. We've included a picture of our safe digging equipment in action while preserving trees at the same time in the accompanying slides. The technology has also been utilized in recent bridge resurfacing infrastructure projects, with the vacuum capabilities providing added efficiencies in the cleanup of related debris.

TRUVAC product demonstrations for the quarter were up 4% (phon) from last year, and our education efforts are also having a positive impact on sewer cleaner demand with the inclusion of the optional safe digging package turning our sewer cleaners into a multipurpose vehicle.

On the new product development front, our R&D efforts continue to drive organic growth. As an example, approximately 75% of our air sweeper orders in June were associated with recent product introductions. In Q2, our SSG team launched the new low-cost ultra low-profile Reliant light bar as part of the group's strategic initiative to gain market share through the expansion of Lights & Sirens product offerings in the value tier.

The Reliant provides customers with an ultra low-profile light bar that is competitively priced while providing advanced programming features and excellent optical performance that enhances the warning effectiveness and appearance of the emergency vehicle. Our Sales team is currently showing the Reliant to customers and are supplying distribution with sample bars for customer demonstrations. Initial feedback from the market has been excellent, and we've received orders and are currently shipping the new product to customers in the U.S. and Mexico.

We have several product launches in the pipeline with street sweeper electrification remaining a key area of focus. We are actively working on our next vehicle in our electrification new product development road map. We've also recently identified an additional battery partner and are continuing to receive positive feedback from customer demonstration.

As we have said before, M&A will continue to contribute meaningfully to our future growth. We are pleased with the progress we are making at integrating OSW, and the teams are energized by the opportunities identified during the 80/20 improvement training sessions we recently held.

Our current M&A pipeline continues to be very active. As Ian noted in his comments, our financial position and liquidity are strong, enabling us to pursue strategic acquisitions, and there are several M&A opportunities that our teams are currently reviewing. Although we may experience some temporary challenges in the near term, we have positioned Federal Signal in a manner in which we will fully participate in the economic recovery by increasing capacity within our facilities, investing in new product development and gaining market share.

Turning now to our outlook for the rest of the year. Demand for our products continues to be high, with our second quarter order intake up 79% compared to the prior year, resulting in a backlog entering the second half of the year which is at a record level. The strength of our second quarter earnings, our record backlog and improving Aftermarket demand in North America gives us increased confidence in the year. Assuming no significant delays in our receipt of chassis from our supplier, we are increasing our adjusted EPS outlook for the year to a new range of \$1.78 to \$1.90 from the prior range of \$1.73 to \$1.85.

We are also encouraged by the long-term opportunities that infrastructure legislation would create for almost all of our businesses. With our recent capacity expansions, we would be well positioned to meet the associated increase in demand for our products.

At this time, I think we're ready for questions. Operator?

Operator

The first question is from Chris Moore from CJS Securities. Please go ahead.

Christopher Moore

Hi, Good morning, guys. Thanks for taking a few questions.

Yes. Maybe just, obviously, recognizing kind of typical seasonality in Q4, given all the uncertainty on supply chain commodity costs from where you sit today, I know it's a big statement, but could you review a little bit in terms of kind of the puts and takes of the relative strength that you're looking at between Q3

and Q4? I know you talked about kind of price increases perhaps hitting in Q4. Maybe could you talk about Q3 versus Q4 a little bit?

Ian Hudson

Yes. I think, Chris, one of the things that we've seen, obviously, in the second quarter was really the strength of the Aftermarket business. Some of that we believe is tied to just what is happening in the marketplace with respect to lead times and the availability of equipment. We've seen a nice uptick in the Aftermarket business, both on the Rental side as well as used equipment sales, both in Canada, where we've seen a really strong utilization really throughout Q2, but we've also seen improvement in the U.S. with the utilization of the fleet. That trend has continued into July, in the early part of July. We expect that to continue to be strong into Q3. As long as the weather stays decent in the northern parts of North America, that could also continue into Q4.

We talked about the impact from the unfavorable price cost impact in Q2. We're expecting something in a similar kind of neighborhood in the third quarter before that starts to turn in Q4. But I think overall, the environment is really—the benefits we're seeing from the diversification of our revenue streams, I think that certainly helped us in Q2, and we would expect that to continue for the balance of the year.

Jennifer Sherman

Yes. I think in a nutshell, look, we're sitting on record backlog. Subject to supply chain constraints, our intention is to produce as much of that as possible. I'd note that we had a \$3 million headwind in Q2. We expect it to be somewhere in that neighborhood in Q3, and we expect that to recover, given the price actions that we've taken to more favorable place in Q4. But again, our objective is to produce as much of that backlog as we can, subject to supply chain challenges.

Christopher Moore

Got it. I appreciate it. That's helpful. Maybe just talk a little bit more on gross margin. Obviously year-over-year they were down 160 basis points. You talked a little bit about some of the things for higher percentage of low-margin chassis and kind of indicated they could be down a little bit near term on a relative basis, but kind of the focus is on share at this point in time. Maybe you could just expand a little bit on the gross margins.

Ian Hudson

Yes. I think, Chris, it's a combination of things.

I think when you look at SSG and the comps that that had in Q2 of last year, we referenced a sizable fleet order that we received and shipped in our European business in the second quarter of the last year. That was a large order with very strong margins. That can sometimes cause some issues with respect to comparisons on a quarter-over-quarter basis within SSG, if there's a large fleet order. Really, that's what we saw in SSG. SSG's gross margin was down about 210 basis points quarter-over-quarter.

We also referenced the fact that last year had the impact of a number of cost saving actions. There were temporary salary actions that were taken as well as the impact of some furloughs. The other thing that is a factor is the medical expense was a lot lower last year with people not going to the doctor. That was a headwind, and that did impact gross margin within SSG.

As it relates to ESG, the gross margin was down about 60 basis points, and there were a couple of moving pieces there, as we referenced, as the chassis mix issue as well as some subcontractor work that we had for our Road Marking Services business. We actually used some subcontracting services there,

and that gets included in both our revenue as well as our costs. That can have a dilutive impact on our gross margins.

There's also the material cost impact that we referenced, which is partially offset by the improved mix from higher Aftermarket business. Then there's also just general inefficiencies associated with some of the supply chain disruption as our teams have kind of maneuvered a number of ways to juggle production schedules to deal with supply chain issues. A number of different moving pieces, but those are kind of the main points.

Christopher Moore

Very helpful. I will leave it there and jump back in line. Thank you, guys.

Jennifer Sherman

Thank you, Chris.

Operator

The next question is from Felix Boesch of Raymond James. Please go ahead.

Felix Boesch

Hi. Good morning, everybody.

Jennifer Sherman

Hi, Felix.

Felix Boesch

I just wanted to start off on the price cost commentary, just to make sure I'm crystal clear. But \$3 million in net headwinds this quarter, similar to 3Q. I think you point to improving trends into 4Q. Would you expect it to be kind of net neutral at that point? And can you just kind of talk about your price visibility into 2022, maybe some of these costs reversing back out?

Ian Hudson

Yes, I think, Felix, certainly, the \$3 million headwind that we saw in Q2, that was mostly within the Dump Truck business. We think that will be in a similar range in Q3, and then that will start to turn. I don't know if it will be net positive for that business overall. But I think for overall ESG, we are expecting it to be neutral in Q4. But there are certain pockets where it will turn at different points in time. I think, overall, it will be neutral in Q4.

As we look further out, as it relates to kind of the pricing power and the pricing dynamics we have, obviously for certain businesses that have longer lead times with backlogs, and this is primarily for sewer cleaners and at the moment, that backlog is already priced. But as, again, we've talked about the fact that we've taken actions to secure pricing on steel for that product line, we feel pretty good going into '22 with the pricing and the cost that we know what we're going to be dealing with.

On the Dump Truck side, we have, as Jennifer mentioned, we've taken a series of actions as it relates to price. We think that as we enter '22, we will start to realize benefits. Certainly, we are expecting that to turn positive as we enter '22.

Jennifer Sherman

I guess I'll add something that we're monitoring it very closely. We're going to take the price actions that we need to in order as we move forward.

Felix Boeschen

Got it. That's very helpful. Then maybe staying on the Dump Body side, could you just broadly characterize the demand environment for us there? And in that vein, sort of maybe how the OSW integration has tracked? Maybe what surprised you getting to know the team more?

Jennifer Sherman

Sure. Sure. Demand for dump bodies has been strong and, as I noted, exceeded our expectations. It's one of the reasons that we were in the position during Q2 that we had purchase steel and we weren't expecting, frankly, the level of demand that we have. The teams really, about a year and a half ago with the new product development initiatives that we introduced there, we're seeing a lot of traction on that. We believe that we're gaining share. Encouraged by the outlook for that particular business and just really overall outstanding Operation teams in some pretty challenging environments.

OSW, we're on track. That's always good to be able to say. Great team out there, a lot of opportunity in that part of the country, given kind of the construction and different activities in the northwest part of the United States. We held our 80/20 training sessions. The teams really responded well. We're very encouraged about the outlook.

The other thing that's encouraging is we're starting to see those teams really optimize production in terms of certain equipment that's going to be supplied by other TBI facilities and then OSW will concentrate on certain types of equipment. Overall, we're in a good place.

Felix Boeschen

Got it. Super helpful. Then I just have one last one. It's on Safe Digging. But I think you point to some pretty big increases in demo activity year-over-year. I was wondering if you could maybe comp that to pre COVID levels. Are you sort of tracking ahead of what you were doing sort of going into the pandemic as it relates to demo activity on that front?

Jennifer Sherman

Yes. We think we're pretty good. I can give you a little bit more detail.

Our TRUVAC demos are up 39% year-over-year. Vactor demos are up 122% year-over-year. Elgin, which you didn't ask but I got the data here, up 38% year-over-year; it's something that we think is particularly important. What's exciting too is we're starting to see even new applications.

Some of the training that we've done, I talked about the utility companies' initiative to bury underground lines for 10,000 miles. We did a demonstration of our equipment to that utility. It was well received. In addition to that, take a look at the slides in terms of some of the environmental benefits that our customers are starting to see and promote; in terms of preserving trees using this equipment, not damaging tree roots.

The other thing that's really encouraging, we talked about the strength of our Aftermarkets business, but we're seeing that strength in our Rental business for safe digging equipment. We believe that we're back to where we were in '19 close, and we'll continue to see progress on that front.

Felix Boeschen

Got it. Then maybe because you brought up, one last I'll squeeze in. But on the Rental side, can you remind us of your geographic exposure on the company-owned fleet? I was under the impression it was very Canada North, up north focus? Any color would be sort of appreciated.

Jennifer Sherman

Sure. We've got strong rental partners that have defined geographies. Our Rental fleet is, as you said, Canadian focused. We also cover the Dakotas, Texas, certain parts of the Midwest. It's really in areas where we have chosen that we're going to move forward and we don't have a rental partner in that particular area.

Ian Hudson

Yes. In terms of units, Felix, it's about a 60-40 split weighted more towards Canada. That's kind of the split.

Jennifer Sherman

But one of the advantages we have is that we can move equipment pretty easily to respond to customer demand. We also supply equipment to our rental—we also supply equipment to our rental partners when needed.

Felix Boeschen

Got it. Helpful. I'll leave it there and pass it on.

Operator

The next question is from Steve Barger from KeyBanc Capital Markets. Please go ahead.

Steve Barger

Morning, everyone.

Jennifer Sherman

Morning.

Ian Hudson

Hi, Steve.

Steve Barger

Obviously, a really strong overall revenue quarter in ESG. As you net out the shutdowns, capacity expansions, Aftermarket strength, is this revenue level of \$335 million sustainable in 3Q? Or does that step down, do you think?

Ian Hudson

I think, Steve, we obviously had benefits from accelerating some of the deliveries prior to the shutdown, so some of that probably moved from Q3 into Q2. But I think we're still expecting strong revenue performance and still meaningful year-over-year improvement in Q3, yes.

Steve Barger

It's possible, just given all the puts and takes that it could be even—could it meet that level of 2Q?

Ian Hudson

Yes, it's possible. Yes.

Steve Barger

Then presumably you're modeling 4Q as the highest revenue level of the year, Jennifer, just going back to your comments that you're going to make as much of the backlog as you can.

Jennifer Sherman

Yes. I mean, some of it depends on supply chain. But, yes.

Steve Barger

Right. You've done a good job managing that so far it appears. Just modeling it out, it looks like if I'm at the midpoint or above on guidance, you'll be back to double-digit incremental margins in the back half. Is it fair to say that 8% is likely the low point of the year for incremental?

Ian Hudson

Yes. I think, as we talked about, Steve, Q3, as it relates to price cost, that will likely be similar to Q2, but we're expecting that to turn in Q4. Yes, I think we would expect that to pick up a little bit.

Steve Barger

Yes. Jennifer, I understand the desire to take market share, even with the margin pressure from expedited freight or overtime. I just have a couple of questions. First, why do you think those customers will be loyal to you in the future, just given everyone's responding to unusual circumstances right now?

Jennifer Sherman

I think that some of the features that the NPD is starting to make a difference. Some of the features and functionality that we offer on our equipment differentiates us from the competition. I think, again, the used equipment market is playing more and more of a role, so the value that our equipment commands on the used equipment market has been in a critical differentiating factor for many of our businesses. Those are two of the critical drivers.

Steve Barger

Yes. What you think, once you convert those customers, they'll stay?

Jennifer Sherman

Yes. That's what we're working for.

Steve Barger

Yes, I know. How do you walk the line between wanting to take share on a specific order versus selling something that might not make as much economic sense just given the margin profile due to these unusual factors? Like what's the thought process that goes into that?

Jennifer Sherman

Again, as we talked about, we're playing the long game here. If there's an opportunity to convert a large strategic customer—typically, people don't buy Federal Signal products across the board because of price; they buy them because of the features and functionality, the reliability and the resale value. We typically try to sell on that. We've been successful with that particular initiative. Very rarely are we in the price game.

Steve Barger

Right. Yes. No, it's just right now with expedited freight and things, you just may have a little lower incremental margin like we saw this quarter, but you don't expect that to last because of the value proposition of the products.

Jennifer Sherman

Exactly.

Steve Barger

Just one more. On the PPG initiative to bury power lines, are there any specific regulations in California that would advantage your products over excavators? I know in some places, they're mandated or required, right?

Jennifer Sherman

Yes. We're not aware of any regulations in California that would mandate use of our product. But as we said, we've been very actively involved in demos, and they've been well received. We think that this is the first of many conversations.

Steve Barger

Great. Thanks for the time.

Jennifer Sherman

Thank you.

Operator

The next question is from Greg Burns from Sidoti. Please go ahead.

Jennifer Sherman

Morning, Greg.

Gregory Burns

Morning.

I just wanted to kind of, I guess, talk about some of the supply constraints. I know it sounds like you have a handle around the chassis situation, so there's not going to be any shutdown. When we think about your ability to produce in the second half, is it more about inefficiencies dealing with the supply chain as opposed to actual shutdowns that we saw from the chassis earlier this year? Or what's going to be the limiting factors or bottlenecks that might limit your ability to produce in the second half?

Jennifer Sherman

Yes. I want to be clear about the chassis situation: it's challenging. We have weekly communications with our teams about the chassis availability. What's challenging is that the situation changes. You think you're getting chassis on a certain date, and then you get a note that it's getting pushed out a couple of weeks. I don't want to communicate anything else, but our teams have done an excellent job in terms of addressing a very fluid situation. At some level, we don't produce chassis, except for one product line, the Pelican at Elgin. We're dependent upon others.

We've seen supply chain challenges across the board. We talked about everything from wiring harnesses, to cylinders, to limitations on epoxy for our road marking equipment. It does feel like, and I've seen other industrial companies use this word, and we agree, it feels like whack-a-mole. We get one thing under control, and there's something else. It creates inefficiencies. We're air freighting things. We're sending people on planes to go pick up chassis. We're doing what we need to do to convert that backlog and meet customer demand. We expect that to continue through the rest of the year. But our teams have done an excellent job in these very challenging circumstances addressing it.

Gregory Burns

Okay. Then in terms of the investments you're making on the Rental fleet, is there any way you could quantify that in terms of number of vehicles, or amount of dollars you're putting into your fleet?

Ian Hudson

Yes. It's something that we track very closely, Greg. I think if you look back to last year, we scaled back the investment in the fleet because we saw utilization levels decline a little bit with the pandemic. As we saw those start to pick back up again, we made the decision to add some more units into the fleet. The net addition has been somewhere in the range of \$10 million, but that also is net of some strong used equipment sales. Again, that's something we monitor closely, because we also track the age of the equipment in the fleet. It's probably been about a net increase of about \$10 million on a year-over-year basis.

Jennifer Sherman

The teams have done a really nice job in a pretty difficult environment beginning in 2020, kind of, one, metering investments down, and then we started last year increasing our investments in the Rental fleet. We're in a pretty good place there.

Gregory Burns

I guess, would your view or your inclination be to continue to invest more dollars there, given what you're seeing? It sounded like I think you had mentioned that, obviously, the Aftermarket and Fleet are strong because supplies are constrained. Okay.

Jennifer Sherman

Yes. Yes. The other thing that's important to note is it gives us other options with our customers. If in fact we're in a unique situation, if we can't provide them a new piece of equipment on their timetable, then we've got either a rental opportunity, or a piece of used equipment.

Gregory Burns

Okay, great. Thanks.

Operator

Next is a follow up from Steve Barger from KeyBanc Capital Markets. Please go ahead.

Steve Barger

Hi. Thanks for taking one more.

Just a modeling question on SG&A. You've talked about some inefficiencies in terms of airfreight, sending people on planes to get the chassis. I'm sure incentive comp is going to be strong this year. But even with all that, given how strong revenue is, is it reasonable to think you can drive some pretty solid SG&A leverage, maybe 30, 40 basis points this year?

Ian Hudson

Yes. I think, Steve, obviously, this quarter, there was some impact because of the SG&A, as a percentage of sales at least, was lower because our revenue included the chassis and the subcontractor in the revenue. That was favorable as it relates to SG&A as a percentage of sales.

But yes, I think, obviously, with our ETI principles, we're always striving to get savings in our SG&A. I think there is always room for improvement. I don't know that it will continue at the same rate that it was in Q2 as a percentage of sales. We're expecting that to revert to kind of more normal patterns in which were somewhat similar to what we saw in 2020, maybe a little better. But, yes, we always aim for improvement.

Incentive comp, as you mentioned, is obviously a big factor in the SG&A line. That's something of an unknown; that's always going to be dependent on how we do the right year. That's the one variable. The other variable we have, and we've referenced this on prior calls, is the mark-to-market liability on the nonqualified plan that flows through that line. That's a little unpredictable at times and really tied to the performance of the market.

Steve Barger

Yes. But just given the strength of the revenue, that's likely to come through in the back half. If you step back up to a high 13% range, you're still going to have some pretty nice year-over-year leverage, it looks like?

Ian Hudson

Yes.

Jennifer Sherman

That's fair.

Ian Hudson

Yes, that's fair.

Steve Barger

Okay, thanks.

Operator

This concludes the question-and-answer session. I would like to turn the conference back over to Jennifer Sherman for any closing remarks.

Jennifer Sherman

Thank you.

In closing, I would like to reiterate that we are confident in the long-term prospects for our businesses and our markets. Our foundation is strong and we are focused on delivering profitable long-term growth through the execution of our strategic initiatives. Federal Signal is in a very good place.

I would also like to give a public thank you to all of our employees, with a special shout out to our Purchasing and our Operation teams at our businesses for their commitment, creativity and dedication addressing this challenging supply chain environment.

In addition, I would also like to express our thanks to our stockholders, distributors, dealers and customers for their continued support.

Thank you for joining us today, and we'll talk to you soon.

Operator

This concludes today's conference. You may disconnect your lines. Thank you for participating, and have a pleasant day.