

**Rheinmetall AG**  
**Investor Relations**  
**Conference Call Q1 2018**  
**Transcript**



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## **Rheinmetall AG Conference Call**

### **00:00:01 Operator**

Good afternoon ladies and gentlemen, and welcome to the Rheinmetall AG Conference Call regarding Q1 results 2018. At this time all participants have been placed on a listen only mode. The floor will be open for questions following the presentation. Let me now turn the floor over to your host, Mr. Helmut Merch.

### **00:00:23 Helmut Merch**

Good afternoon, ladies and gentlemen. A warm welcome from my side to the Q1 analysts' conference call! Thank you all for joining. I will first walk you through the quarterly presentation and afterwards you will have the opportunity to ask your questions.

Before we begin, I would like to inform you that during this call, we will give forward-looking statements, which involve risks and uncertainties as detailed in our disclaimer. Let's get started with the highlights on page number three.

Looking at our two businesses, Q1 shows a mixed picture. However, we were able to stabilize our operating margin and EPS, and order entry was a definite highlight of the first quarter. The positive market environment remains intact, but our business was impacted by unfavorable FX developments in both segments. Furthermore, Defence was impacted by supplying issues and sales postponements at customer's request.

Absolute EBIT went down by €3 million and we achieved €47 million in Q1, leaving the operating margin unchanged at 3.7%. Operating free cash flow was slightly down compared to Q1 2017, but the main driver was working capital build-up in Defence. Looking at EPS, we were able to almost fully compensate the lower EBIT by an improved interest result, leading to an EPS of €55 cent after €56 cent last year. As I will elaborate in more detail at the end of the presentation, we confirm our full year guidance for 2018.

Last but not least, our efforts to improve the balance sheet were rewarded by Moody's upgrade to investment grade Baa3 stable published last week.

Moving now on to page number four.

Group sales decreased by 6.6% to €1.260 million. While both segments experienced unfavorable FX developments, the main drivers were operational developments in our Defence segment, which I will present in more detail in a couple of minutes.

While the operating margin remained at the same level as last year, absolute operational result fell slightly by €3 million and was €47 million

after €50 million last year. Main driver was €2 million came from adverse FX developments. The restatement of IFRS 15 and 16 has not resulted in any material effect on sales or operating result. We will report the effects on a quarterly basis.

Please turn now to page number five. Operating free cash flow was impacted by additional working capital requirements of Defence and declined by €88 million to minus €287 million. The impact from IFRS 16 was minor. Earnings per share of €55 cent were practically at the same level compared to last year, because the reduced EBIT was almost fully compensated by a lower interest result, which reflected the benefit of the bond refinancing last year. Headcount increased by 2.5%.

Page number six presents details on our net debt position and the development of the equity ratio. Our net debt increased to €219 million coming from €75 million, which was a restated starting point after IFRS 16 adjustment of leasing liabilities of €155 million. The increase of our net debt is in line with the typical swing during the year and compares to €182 million at the end of Q1 2017. But here you have to see that the €180 million is not an adjusted figure.

On April 27th, Moody's published the rerating of Rheinmetall to investment grade now to Baa3 stable outlook, which was a positive recognition of the efforts and improvements we have made over the last years.

The implementation of IFRS 15 and 16 extended our balance sheet by €221 million including €155 million leasing liabilities and a net effect of €66 million in relation with cost for obtaining orders. Due to the positive net income development, equity ratio improved by 60 basis points to 31% compared to the adjusted figure.

On the next page we continue with our segment analysis starting with Automotive.

At first glance, Automotive growth in Q1 seems not as strong, but comparing this to a Light Vehicle growth of minus 0.7% and taking into account unfavorable FX developments, an operational increase of 4.8% paints a different picture. So it was a good start into the year.

Strong pillars for this increase were the supporting growth trends in the truck business and the performance of our Aftermarket business, both segments achieving more than 10% growth rate. All three divisions were able to increase their operating results, which brought the segment margin to 8.6% or 20 basis points above Q1 17. Operating free cash flow improved by €68 million to minus €50 million on our efforts to optimize working capital.

Marketwise, we observed down-trending Diesel sales, but on the other hand non-LV business grew very strong at 14% and in combination with a stable gasoline related sales, both were able to compensate for this development.

Please turn to page eight for the analysis on divisional level.

We have included FX adjusted growth figures in the divisional breakdown in order to provide a better view on organic growth of each of the businesses.

Mechatronics sales grew organically roughly 2% countered by 1.1% FX effects, rising €4 million to €429 million. Furthermore, we are comparing versus a high base effect, because Q1 2017 reported a growth of roughly 15%. Operating results rose accordingly, now standing at €44 million after €43 million last year. Growth was largely driven by good truck-related demand for our Commercial Diesel Systems.

Organic growth in Hardparts accounted for roughly 8%. After negative FX effects this melted down to only 2% resulting in an increase of €5 million or a total sales of €254 million accompanied by a positive margin development of plus 30 basis points to now 7.1%. One key driver behind this was a high demand for our Bearings business and furthermore, we benefit from the further recovery in our Brazilian site.

Aftermarket enjoyed a good momentum in the first quarter and grew almost 11% to €92 million; the FX exposure played only a minor role. Profitability improved further to 8.7% resulting in an operating result of €8 million. And the division is benefiting, actually, from an overall good demand situation, especially European demand was supportive. Moving now onto page number nine for our regional comparison.

Q1 2018 experienced a regionally diverse market development. Light vehicle production in Germany, NAFTA, and China declined, offset by the growth in the rest of Europe, Asia (excluding China), and Brazil. In Japan, we reported a sales growth of 26% versus 0.5% market growth and India even 39% versus 6.7% market growth.

On a global scale, the Light Vehicle production volume as already mentioned, contracted by 0.7%, while our business grew 1.9% or even 4.8% FX adjusted.

On slide 10, we broke down the business activities of our joint ventures and our 100% subsidiaries in China. Organic growth of 4.5% of all our Chinese activities showed the opposite trend to the market development of minus 3.3% in the first quarter. However, Q1 was marked with start-up costs in our new plant and the unsynchronized in- and out-phasing of products in our 100% subsidiaries. This situation should be overcome in Q2 already.

With this, I would like to proceed to our Defence segment starting on page number 11.

The demand for our products remains strong. News flow on the Boxer from Australia is extremely encouraging and we are confident to sign the contract in H2. In the first quarter of this year already, we realized an order entry of €857 million for Defence, which doubled the figure from Q1 2017 of roughly €390 million. In other words, the sustainability of our growth ambitions in Defence is further strengthening.

In Q1 2017 we reported a sales figure of €612 million and achieved a superb growth rate of 16%. In our call one year ago, I mentioned that this business is volatile. This year, we have the opposite development and I have to present a sales figure clearly below previous year's Q1.

Out of the decline of €103 million, €15 million come from negative FX effects, and I will come back to the other reasons for the operational reduction in a minute. The sales effect did not fully carry through to results, because operational improvements were supportive and operating results only declined by €3 million to minus €13 million. The delays in the sales execution contributed to an increase of the working capital, which of course impacted the operating free cash flow negatively. Let us now have a look at the divisional development on slide number 12.

The division Weapon and Ammunition sales and results were influenced by three main reasons. First, a very strong Q1 2017, which reported very high margin sales, with, for instance, one license agreement accounting for an isolated effect of around €3 million in sales end result. Second, customer's decision to combine shipments, with dispatch in Q2. And last but not least, missing export approvals due to the late government formation in Germany.

Electronic Solutions sales declined by €12 million to €126 million on timing pattern of the order book. Results improved by €3 million due to a lower cost base and the reduction of losses in Norway. The first quarter for Vehicle Systems was impacted by a bottleneck in the supply chain for trucks. At the end of March, roughly 250 trucks waited in Vienna for final assembly, burdening our inventories. This issue blocked the delivery, affected sales, result and cash flow. And the sales equivalent for this roughly 250 vehicles was roughly €50 to €60 million.

Additionally, Q1 saw the phase-out of the Dutch Boxer, burdening sales, but with a slightly positive result effect due to the absence of the negative contribution. A further support to the results was a reduced cost base and a favorable sales mix.

Moving on to page 13 for the details of the order situation.

All three divisions reported an increasing order entry. The largest contribution came from Weapon and Ammunition totaling to €617 million including one major order for an international customer accounting for around €380 million. The backlog for the remaining three quarters in 2018 stands actually at the end of March at €2.5 billion. So including Q1 sales of €500 million and expected orders that turn into sales until the end of the running year, we remain confident to achieve our targeted growth of 12% to 14%.

Please turn to page number 14.

Q1 was a good quarter for our vehicle Boxer. The vehicle is already in service in the German, the Dutch and the Lithuanian armed forces in various versions. The nomination of Rheinmetall as a preferred bidder by the Australians and the announcements of Slovenia and the UK to join the OCCAR, are a testimony of the potentially bright future of this vehicle. While we are expecting to finalize our contract negotiations with Australia in H2, the process with the other two nations is actually in its early stage. Especially the UK still has a long way to go, before we might see an actual order on the table.

Please now move onto page number 15.

As an exception, we have decided to provide a more detailed forecast on the second quarter on segment level.

In Automotive, we are expecting a continuation of the overall positive market environment. Q2 sales should grow clearly above the rate of the first quarter and we anticipate a positive leverage effect on our margin. But FX effects from translation should continue to influence our business negatively.

The Defence segment in 2018 once more will be very back-end loaded since Q2 sales are expected to be flat year on year. However, we are confident that the substitution of last year's major ammunition trading contract of roughly €112 million with new sales of a significant higher added value in Q2, will be supportive to the margin development in this segment. So, adjusted for the trading contract, our Defence business is expected to grow at a double digit rate in all three divisions during Q2. FX headwinds are expected to persist in Defence as well.

I will now conclude my presentation with some remarks on the full year guidance page number 16.

Regarding the full year guidance we are confident to achieve our targets and therefore we confirm our statements from mid-March. Especially Defence is expected to contribute with strong accelerated growth in the second half of 2018. This assumes however that we will not have any

stronger headwinds from FX in both segments, nor any deterioration in the global trade relations. On the background of the first quarter FX effect, we are currently assuming that the full year will be exposed to a FX pressure of around €100 up to €120 million on the topline in comparison with last year.

Ladies and gentlemen thank you very much for your kind attention, and now I'm ready to take your questions.

**00:18:42 Operator**

Ladies and gentlemen, if you would like to ask a question, please press nine followed by the star key on your telephone keypad. In case you want to cancel your question, please press nine and the star key again. Now press nine and the star key to ask your question. And the first question comes from Alexander Hauenstein, DZ Bank.

**00:19:07 Alexander Hauenstein**

Yes hello. Thanks for taking my questions.

First of all, I remember you basically guided for three drivers in 2018. First of all, the large contract in vehicles, the second, Gladius and third, air defense on both electronic solutions.

For Ammunition, you guided at the turn of the year 2017 to 18, towards a flattish development year over year. And my question is now is the recently announced €380 million international customer contracts which runs for three and a half years, is this to be seen on top or is this already included in your fiscal year guidance? I mean Ammunition is short notice business, right? So that would be interesting.

**00:19:53 Helmut Merch**

Yes, thank you Mr. Hauenstein for the questions. Starting with the last one, the €380 million is for tank and artillery ammunition. And these rounds have a long lead time, and therefore the €380 million will not be part of sales in 2018. Therefore the first deliveries we expect from 2019 onward. So, I will confirm our statement from last year that Weapon and Ammunition will be more or less flattish compared to 2017.

**00:20:37 Alexander Hauenstein**

Okay thank you very much for the clarification here. And you mentioned in Defence the bottlenecks at the suppliers, especially on the truck side and on top of that the customer-induced delivery delays. So with the delivery delays I understand you expect probably a major catch-up already in Q2 or is that more have to be loaded to the second half then?

And also related to the supplier bottle necks, is this a one-time effect only? Or is this something more structured that can last longer, maybe even into the next year? Maybe a bit more color on the causes and the impact would be helpful. Thanks.

**00:21:18 Helmut Merch**

So the bottleneck, I think it was the first time that we reported about the bottlenecks in our supply chain. So this should be a temporary effect. Unfortunately, it belongs to some pumps and we are not in the position to deliver from our own factories, but anyhow there is a shortage and we are heavily discussing with the sub-supplier to overcome this bottle neck in the next couple of months.

Therefore, I cannot confirm that the full delay will be caught up in Q2, but we are working heavily and I think this should be overcome at least in the next four to six months. And therefore, I will not assume that this will be a continuous problem lasting until next year.

What was the other question? I missed it.

**00:22:26 Alexander Hauenstein**

Whether the expected catch-up in earnings ...

**00:22:30 Helmut Merch**

Ah okay. So I guess the delays due to postponements by customers were around €10 to €15 million. So I think most of it will be caught up in Q2. But what I'm saying is that on Q2 sales in Defence, we overall expect a flat development in a year to year comparison. But here I tried to explain we had an enormous effect from the trading contract with €112 million and this trading contract will be fully compensated by own products with high vertical integration. So therefore, I think the growth to be expected to catch up the missing sales in Q1 in Weapon and Ammunition will be seen in H2 this year.

**00:23:42 Alexander Hauenstein**

Okay thanks a lot for clarification.

**00:23:45 Helmut Merch**

Welcome.

**00:23:47 Operator**

And the next question comes from Christoph Laskawi, Deutsche Bank.



**00:23:53 Christoph Laskawi**

Hi, thanks for taking my question. The first one, or the first two on Automotive and then on Defence, if I may.

The Auto results are quite impressive and you showed a decent operating leverage of above 20%. My question would be: Has anything changed on R&D spend in Autos? Was that lower compared to last year? Or is it just an underlying improvement of the better utilization, better product mix?

And then the second one on Autos, you highlighted declining diesel demands for a slow-down in Mechatronics. Looking at the market, we see that the diesel might pick up in H2 again if fleet customers come back with a higher share in registrations. Do you see something like that as well in your orders? Could it, hence, accelerate into H2 the Mechatronics growth? Or is that until now not that visible for you?

And then on free cash, the working capital swing, is it expected to be in Q2 already? Or will it spread over the next quarters?

And just a clarification on Defence: With flat Q2, absolute revenues you implicitly guide for around 30% growth in H2, if you could confirm that. Thank you.

**00:25:24 Helmut Merch**

So starting with the last question, yes if we expect a flattish Q2, then the whole growth has to come and is to be expected for H2. Again, with a very much back-end loaded development that means we will see a very, very strong Q4.

Then I will move to Auto. We are not benefitting from lower R&D expenses. We have the same level compared to last year and we are not willing to reduce. We have to spend for different reasons on a high level, and this we will continue. The operating leverage you have mentioned, is also partly dependent on a better product mix, but also on a high utilization. And I give you only one small example. The recovery in our Brazilian factory leads to a turnaround after facing losses in Q1 2017. We now have more than break-even in our Brazilian sites, and this also helps to stabilize and also slightly improve our operating margin.

The last questions regarding diesel, I think it is a little bit too early, that we will see a possible recovery. I think we are fully prepared for a potential recovery, but we do not see for the time being any positive signal.

**00:27:18 Christoph Laskawi**

Okay, thank you. And on the working capital impact on free cash?

**00:27:22 Helmut Merch**

Free cash flow, I think we saw a nice development in Q1. I think we will work on a similar development, not as high compared to Q1. But we will see a stable development during the next three quarters ending up with a positive free cash flow for the full year, which we have also guided in the past.

**00:27:52 Christoph Laskawi**

All right, thanks a lot.

**00:27:56 Operator**

The next question comes from Sven Weier, UBS.

**00:28:01 Sven Weier**

Yes, Hello Herr Merch. A couple of questions from my side. Maybe you can take them one by one.

The first one is coming back to the UK potential contract, I guess on this one you haven't really spoken publicly yet. I was just wondering in terms of the potential size of the contract, you were mentioning 500 vehicles here, which is the intention. You had about 200 in Australia, so does it mean that the potential size of the order in general euro volume would be more than double the Australia one? That would be the first question, please.

**00:28:38 Helmut Merch**

Here you have to bear in mind that we are discussing two different vehicles. The Australian ones are more or less fully equipped with turrets. And the turret, as you know, is one of the most expensive parts. And therefore you cannot calculate simply volume by unit. This is one thing. And looking to the UK: Here, we have the situation that we are bidding together with KMW out of the joint venture ARTEC, as you know. And therefore, the volume which will come to Rheinmetall will be significantly lower compared to the published figure of €4 to €5 billion and therefore we are, for the time being, a little bit reluctant to post a concrete figure. But actually to have one figure in mind, internally we are looking for roughly €1 billion plus.

**00:29:56 Sven Weier**

Okay that's clear. The second question I have, obviously we see a lot of momentum on these very large contracts now. I was just wondering if you could also elaborate a little bit what's going on in these small and mid-size tickets, because, I guess, orders like this €380 ammunition contract are

quite respectable as well. So do you see a similar strong volume in this segment as well ongoing?

**00:30:22 Helmut Merch**

Yes. I think what we have announced in the last two weeks was also one nice air defense contract in a lower triple digit size. Therefore, I think also to give you some flavor, also our German order intake is going on and therefore I think we have enough small and medium sized orders in the pipeline that we do see a nice mixed picture of different sizes. I think the lighthouse project, like Australian is very interesting, but I think the running business is more or less dependent on the small and medium sized orders.

**00:31:26 Sven Weier**

And then if I can ask you, there was a report that Turkey is now going ahead with your joint venture partner in building the tanks with the first order I think of 250 battle tanks.

**Helmut Merch**

Yes.

**Sven Weier**

I understand it's a sensitive issue, so I was just wondering if there was any comment from you at all on this topic.

**00:31:41 Helmut Merch**

I think, actually, what we have bid for is protection for the existing Leopard fleet in Turkey. Here, we have still the situation waiting for government approval, which we didn't get so far. And due to the various reasons in the political arena, I do not want to speculate if or when we could possibly get this approval. The thing around 250 units of Altay, I do not want to comment for the time being.

**00:32:35 Sven Weier**

And then the last question I had for you was just about the, when we think about when all these orders that you've talked about largely come into revenues after 2020 and I guess we're all kind of more or less modeling a €4 billion Defence business for 2020. So is it fair to say that your revenues beyond 2020 will be significantly above the 4?

**00:33:00 Helmut Merch**

I'm happy if I can look and give some flavor for the next two or three years, and we have given this flavor when we stated that we want to grow at average with a CAGR of 10%. If you model these expectations, then you

could end up with a figure of above €4 billion. But I do not want to combine this figure with a concrete year.

**00:33:40 Sven Weier**

It's what I'm assuming because what's phasing-out is much smaller than what is phasing-in. So that's where I'm coming from.

**00:33:48 Helmut Merch**

That is right, but on the other hand I'll give you only one example, looking for the UK contract which will be negotiated hopefully during 2019. Here the first deliveries will start not before 2023. Australia is slightly different here, we expect first deliveries on small volume already in 2019. But the real ramp up we expect for 2021.

So there is still some time span to go, but anyhow what is promising is that there is a strong demand for a lot of vehicles in our portfolio and also the potential tenders which may be announced in the next couple of quarters should also give some flavor to what one could expect. But I think the market environment combined with our present product portfolio keeps us confident for our expected growth scenario, Mr. Weier.

**00:35:12 Sven Weier**

Okay thank you, Mr. Merch.

**00:35:16 Helmut Merch**

Bye, thank you.

**00:35:18 Operator**

At the moment, we don't have any further questions. So I would like to repeat and give you last call. If you would like to ask a question, please press nine and the star key.

And the next question comes from Christian Cohrs, Warburg Research.

**00:35:36 Christian Cohrs**

Yes good afternoon. Thank you for taking my questions.

**00:35:38 Helmut Merch**

Good afternoon.

**00:35:39 Christian Cohrs**

Good afternoon, Mr. Merch. First, maybe in the Q1 report, you also mentioned that you faced fewer export licenses, I assume due to the political standstill in Germany.

**Helmut Merch**

Yes.

**Christian Cohrs**

I wonder whether this is gradually fading out already. Do you feel positive impact that a new government is in place? Or what should we expect? How long will it take until this bottleneck or the consequences of this bottleneck will be fully diminished?

Secondly, your outlook for Q2 actually implies that the midpoint of your divisional Defence guidance implies approximately 28/29% revenue growth in H2. So are you capable to handle that actually with your current workforce?

And lastly a question on the UK contract: So I'm not mistaken, I think part of the contract or part of the idea in the UK is that the Boxer will be produced in the UK, but also exported from the UK. And I wonder whether you need consent by the German government for that approach. And I wonder what your view is regarding chances to actually receive consent from the German government having in mind that I think the UK is less restrictive with regard to its export criteria.

**00:37:18 Helmut Merch**

Yes, interesting questions. They cannot be answered at full, because we are not at this stage actually.

I think the assumption that we have a high local content is right. We actually are assuming a local content of roughly 60% of being produced in UK plants. We will prepare a necessary facility and site, and we also will establish a good supplier basis in UK. So firstly, we will start, in case we will get the order, we will start with a delivery for British vehicles. And when we have a British site, I think there is a good potential getting the approval from whomsoever to export from UK. But I think it is too early to give a final statement to these questions. Therefore, I think you should raise these questions in a couple of years once more.

The second situation regarding expected growth, yes your calculation is right. We see a huge growth coming in H2 and we're actually also preparing the growth by building up working capital. I think that also will burden free

cash flow and therefore working capital during Q2 and Q3, because we have the necessary staff more or less onboard in our site and they have to work. Because, as you know, we have through the order book of €2.5 billion and the work is in our factories, and we have to pre-finance in some cases and to prepare the necessary shipments in Q3 and Q4. And I think, to compensate some peaks, we have to hire some additional temporary workers.

Then coming back to your question regarding missing export approvals: The effect was not as much, around €5 to €10 million, and here we see not an immediate relief because the first meeting of the so-called Bundessicherheitsrat [Federal Security Council] as you know will take place end of May, beginning of June. And then getting, hopefully, some answers to our questions, we see a possible relief of this specific order not before Q3. But anyhow, actually we do not see a signal of a more tighter decision making, but anyhow we have to wait for the meetings of the Bundessicherheitsrat.

#### **00:40:59 Christian Cohrs**

Okay. That's helpful. Maybe just one brief follow-up question. You mentioned the order backlog which I think will contribute roughly €2.5 billion in the remainder of 2018 and the Q1 results. So this brings us to a total sales volume of I think €3 billion more or less. And so the remain numbers actually come, if you guide for roughly €3.4, so that means that €400 million sales must come via the spot business.

#### **Helmut Merch**

Exactly.

#### **Christian Cohrs**

And you think that is a reasonable figure and also can you remind us what is, given Rheinmetall's current set-up, what is usually the spot business you can actually take, handle and convert into sales within one year?

#### **00:41:50 Helmut Merch**

Yes. It depends a little bit. Sometimes it's a timing question regarding customer demands, but I will give you a span. Normally we have order intake turning into sales in the running year, at an average of roughly €550 up to €600 million. And last year we exceeded this figure there. There we made some €700 million, but this was an exceptional year. That is not a volume which is underlying in our expectations. So saying this, your €400 million, it should be covered in a normal year and we expect 2018 as a normal year which has an extremely good order backlog at the beginning of the year. So the answer is yes.

**00:42:55 Christian Cohrs**

Okay understood. Very helpful, thank you.

**00:42:58 Helmut Merch**

Thank you, Mr. Cohrs for your question.

**00:43:01 Operator**

The next question comes from Sebastian Growe, Commerzbank.

**00:43:06 Sebastian Growe**

Yes, good afternoon everybody.

**00:43:08 Sebastian Growe**

Three questions from my side. The first one is a follow-up on the impact from the delays in forming the new government in Germany. Can you also quantify eventually the impact that it might have had on the order intake in the first quarter? From my understanding was that there was a certain spill over eventually of orders that did not really make it into the Q1 recognition and will then fall into second quarter.

And then along those lines, it was just on the wires today a story that the Christian Democrats are thinking about a more aggressive defense spending going forward. Maybe you can just share your views on that point, and then I would have two more questions on Auto.

**00:43:49 Helmut Merch**

So you are right. The impact on delays on order intake is higher than the impact on the sales. But here we have two different items: A, the expected order intake from Germany and the expected approval for export out of Germany. So it is a double layer and the major impact we saw in Q1 was the order intake missing from Germany due to the fact that we have not a fully functioning government. And now we expect a positive impact from German order intake for the second half of this year.

**00:44:48 Sebastian Growe**

And would you be able and even more so, willing to quantify that?

**00:44:54 Helmut Merch**

I think it is a number of €150 up to €250 million.

**00:45:03 Sebastian Growe**

Okay, very helpful. Thank you for that. And then on the other part of the question with the general thinking of the Christian Democrats being more aggressive on eventually increasing the budget for defense.

**00:45:15 Helmut Merch**

I think the media, actually, is full of information from various political statements. I will not and I don't want to comment the different opinions. What is actually in the discussion and I think it is the right discussion, we have to spend more on defense and now it is a matter of how much and when. And I'm not able to give a concrete comment on this, but I think the necessity of spending more is now in all the heads being involved in the final decision making. Actually, in the past it had been doubted that we will reach the 2% which has been promised at various occasions. But I think we will move in the right direction and I think for 2018 and 2019 the signals are very clear now. I think the basic discussion is around how fast will the development from 2019 beyond be and I think this discussion will last, that is my opinion, still for the next couple of weeks.

**00:46:50 Sebastian Growe**

Okay, that's helpful. Then moving on to Autos, the first one on the Mechatronics and the question was asked before on the diesel outlook that you give.

If I look at the first quarter then clearly, you had high comparables on Mechatronics in the first quarter 2017, which I think apart from the diesel situation as such, clearly also the reason why growth was rather slow - currency, some other things, but from a more structural point of view and where diesel currently stands in the overall kind of buying willingness of people, thinking about making an investment to a car, where would you really see the structural growth potential from today's point of view for the Mechatronics division? So, I think we got used to at least mid-single digit growth rate, eventually even a little higher. So where do you think that could settle over the next, say two or three years, eventually?

**00:47:43 Helmut Merch**

I think the trend for products to reduce emissions and to reduce consumption is unbroken. So, what we have seen in the last couple of quarters, that the continuous downturn in diesel we have more or less fully compensated by gasoline products. Now at this point we saw for the first time some real impact in our diesel business. But now fortunately we saw some strong demand for our commercial diesel systems and what we see that the CO2 targets, which are still in place, will be one of the ultimate drivers for our Mechatronic business. So yes, we are fully confident that we



see further growth in Mechatronics, always assuming that the trend in the light vehicle production will be a positive one. But I think the underlying drivers are what we explained also during our capital markets day, so therefore we are confident of the future growth potential of the Mechatronic business.

**00:49:15 Sebastian Growe**

Okay and then finally on Aftermarket, I was surprised to see such a strong growth in the first quarter. Is this the new normal? Or is this really a one-time spike? Or should we simply think about the growth potential for Aftermarket?

**00:49:29 Helmut Merch**

I think 10% is not the new normal, but I think growth should not be a one-time effect. Therefore we are actually expecting a higher growth in Aftermarket compared to the last years because now we see a positive mix effect, we see a stronger trend for our Mechatronics products. In the Aftermarket, the Hardparts products are a little bit weaker. What we see regional-wise, Eastern Europe is very strong. And here we saw some real downturn in the last couple of years and here, also a positive recovery in the market gives us a tailwind. And also, an additional thing is, that we elaborated new sales channels to get more customers. So we are working also on the structural base of our Aftermarket business.

**00:50:36 Sebastian Growe**

Okay, that's very helpful. Very clear, thank you.

**00:50:42 Operator**

The next question comes from Sash Tusa, Agency Partners.

**00:50:47 Sash Tusa**

Thank you very much. Good afternoon, Mr. Merch. I've got two financial questions. One is, could you just explain the €155 million of leases that you have now reclassified under IFRS 16? What do these refer to? And then my second question is that you talked about €60 million of costs or €66 million of costs to obtain orders and I didn't, I'm afraid, understand the treatment of those, where those appear and why that is a different accounting treatment. Thank you.

**00:51:25 Helmut Merch**

Okay Mr. Tusa. And now I have to wait for some answer. Please wait a second. The lease liabilities are more or less referring to buildings which we

had before off-balance and now we have to keep them on-balance. So, roughly from this €155, €140 million belong to buildings and the rest referring to Light Vehicles and some machinery equipment in our sites.

**00:52:12 Sash Tusa**

Thank you. And those buildings are broadly split between the two businesses. Would that be right?

**00:52:21 Helmut Merch**

Yes, more or less. Yes, more or less. But the concrete split, I have not in mind. But looking at the issue, what we have made, I think the assumption is not as false so far.

So the €66 million, I have to wait for an answer. So here we have to activate costs together with contract acquisitions and this is mainly belonging to commission fees and to offset requirements.

**00:53:02 Sash Tusa**

Okay, great. Thank you very much indeed.

**00:53:08 Operator**

The next question comes from Alexander Hauenstein, DZ Bank.

**00:53:15 Alexander Hauenstein**

Yes, hello. I wanted to follow-up please. I understand you contributed around €40 million to the CTA funding. And will you continue to do this here or have you reached a target level already? And is this something only for a first quarter? Or could you decide to do this generally every quarter? I mean probably not in the same height, but something which only happens in Q1.

**00:53:39 Helmut Merch**

Yes. Mr. Hauenstein, we are completely free to fund the CTA every quarter, but we have a certain target which I have explained last year. We want to reach a level of out funding our German pension liabilities in the range of 50% to 60%, comparable to the majority of the MDAX and DAX corporates. And in the German pension liabilities, we are actually facing €1 billion. So we reached 10%, so we have some miles to go and we will decide every year how much we will fund. And this decision is highly dependent on the yearly free cash flow we are able to generate. So after having seen a good development in 2017, we raised our funding from €30 million up to €40 million. And normally having seen the year's end results, then we decided at

the board level to fund and then we actually are funding the CTA in the first quarter of the year.

**00:55:04 Alexander Hauenstein**

Okay, thank you. So mainly nothing really changed.

**00:55:09 Helmut Merch**

No. No, for this year, we will not fund anymore.

**00:55:13 Alexander Hauenstein**

Okay, thanks.

**00:55:17 Operator**

The next question comes from Sven Weier, UBS.

**00:55:21 Sven Weier**

Yes, a couple of follow-up questions, please, on Autos. First of all, you mentioned that the LV related sales went down 0.7%. I was just curious, is that already currency adjusted? Or is that on a debt or on a currency adjustment basis for you?

**00:55:40 Helmut Merch**

No that is only a volume-related figure. Light Vehicle production on Global scale. That is minus 0.7.

**00:55:51 Sven Weier**

Because if I have a look at slide seven of your chart, the first bullet. It mentions that your non-LV trucks plus 16% versus LV minus 0.7%. So does trucks in LV in that first bullet relate to the market and not to your performance?

**00:56:09 Helmut Merch**

I think that is a little bit misleading. So the truck business is not related to the Light Vehicle market. Here you are completely right. If I look especially at the truck-related numbers worldwide, then we see that the figures following IHS, here the truck market is roughly 1% higher compared to Q1 17, and our truck business performs on the growth rate of 16%. We also clearly outperformed the reference number of the worldwide truck market. But you are right, trucks plus 16% have nothing in common with the Light Vehicle production.

**00:57:02 Sven Weier**

So the trucks plus 16% is your own number and the LV minus 0.7 is the market number.

**00:57:07 Helmut Merch**

Exactly. But you are right that it's not something we should put together.

**00:57:16 Sven Weier**

But could you give us a sense if your LV business was performing in line with the market or better if you isolate your non-LV business?

**00:57:26 Helmut Merch**

It was slightly better.

**Sven Weier**

Slightly better, I see.

**Helmut Merch**

Slightly better. But not compared to our FX adjusted number of 4.8% because this number was, as I tried to explain, was mainly driven by Aftermarket and the truck business. But the isolated reference number for light vehicle production, here we saw a slightly better performance compared to the market.

**00:58:03 Sven Weier**

And was there also an impact from different timing of Easter on the Auto business?

**00:58:10 Helmut Merch**

Yes. Sure, especially here in Europe, I think we missed two days. And that means roughly 1% to 2%. And therefore, now looking for Q2, this makes us confident for a clearly better growth rate in Q2 compared to Q1. Also, the expectation for IHS for the whole market is clearly better compared to Q1.

**00:58:44 Sven Weier**

Yes. And then I have one last follow-up, please, and that relates to I think Bosch has announced what they think of the revolutionary diesel technology, new one. And I think as a layman to me, it appears that they

have done something to the air handling and improved that quite a bit. Is that something you have been involved with your components as well? Or would you have any comment on that one?

**00:59:11 Helmut Merch**

No. We have nothing to do with the diesel product from Bosch. And for our perspective it is still unclear what Bosch has in mind. Therefore, I will not comment on this announcement, Mr. Weier.

**00:59:36 Sven Weier**

Okay. Thanks again.

**00:59:37 Helmut Merch**

On the other hand, I want to say that we have enough products in our pipeline that could help OEMs in meeting the necessary targets. But it is always a matter of price and also pressure on the OEMs. And I think here I want to repeat it once again, there are still existing CO2 targets for 2021 and these targets will be one of the strongest drivers for our forthcoming business for Mechatronic products.

**01:00:19 Sven Weier**

Yes, understood. Thank you, Mr. Merch.

**01:00:24 Operator**

So at the moment we do not have any further questions. I would like to repeat ladies and gentlemen, if you would like to ask a question, just press nine and the star key. The combination for your question is nine and the star key on the telephone. No, Mr. Merch, there seem to be no further questions.

**01:00:51 Helmut Merch**

Okay, so thank you all for joining our call and have a good weekend. Bye-bye.