

Rheinmetall AG
Investor Relations
Conference Call Q3 2018
Transcript



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Rheinmetall AG Conference Call

00:00:01 Operator

Good morning ladies and gentlemen, and welcome to the Rheinmetall AG Conference Call regarding the Q3 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.

00:00:24 Helmut Merch

Good morning everybody and welcome to our third quarter earnings call. Thank you all for joining us. As usual we start with the presentation and then you will have the opportunity to ask questions.

I would like to remind you that during this call we will give forward-looking statements, which involve risks and uncertainties as detailed in our disclaimer.

Before we begin with a discussion of our financials, I would like to start with some opening remarks on the terrible incident that occurred at our plant in South Africa.

As you are probably aware, a severe incident occurred on the third of September 2018 in our ammunition site in Somerset West in South Africa. The explosion was so enormous that one building was completely destroyed. Eight of our colleagues lost their lives. We mourn with their families and offer continuous support to their surviving dependents.

The material used in this factory was mainly so-called guncotton which serves as an ignition material for ammunition charge systems. The security system of the production had been inspected as satisfactory only two weeks before the incident. Due to the extent of the explosion it is very difficult to identify its exact cause. The local authorities have blocked access to the site of the explosion and are trying to analyze the traces. We are working closely with their experts, but we do not expect to receive results any time soon. Right now, it is also difficult to evaluate the consequences for the sales and earnings development. We actually estimate that orders valued at around €30 million cannot be realized this year and will likely be shifted into the next year.

Let us now start with the review of our financial performance on page 4.

For a number of reasons, Q3 was a particularly challenging quarter. Automotive stayed clear of the market difficulties characterized by a number of profit warnings on OEM and peers level, which were provoked to a large extent by the ongoing WLTP and Diesel discussions.

Defence was shocked by the aforementioned incident in South Africa. News on successful order wins clearly were pushed into the background. However, from a commercial perspective, both segments held up solidly.

For a closer look at our financial KPI please switch to page number 5.

Group sales in the third quarter grew operationally by 5.0% to €1.411 billion, held back by negative FX effects of 1.7%. The operating result was broadly flat year-on-year gaining €1 million or 1% to €98 million. FX effects were again adverse, but to a lesser extent than in the first half of this year. Earnings per share increased strongly by €97 cent to €1.80 cent. In Q3 last year, we reported restructuring charges of €22 million in the Automotive segment. Conversely this year, we reported a profit of €30 million related to a real estate project in Hamburg.

Let me continue on slide number 6.

Earnings after tax and D/A supported our operating free cash flow. The position showing delta working capital and others increased again in Q3 in both segments. Capital tied up in inventories and delayed prepayments of roughly €130 million were the key drivers of this development. Furthermore, the correction of the real estate cash effect of €30 million in the operating free cash flow is reported under this position.

Although we are expecting a significant improvement of working capital in the remaining quarter of 2018, let me remind you that Q4 2017 was an exceptionally good quarter with high prepayments and we currently do not expect this situation to repeat in Q4 2018.

Please move on to page 7.

Net debt amounted to minus €514 million after a minus €242 in Q3 2017. Obviously, the requirement to finance the business-related increase of our working capital caused this development. The equity ratio reported a further slight improvement of 2.2 percentage points to now 32.6 compared to the beginning of this year. Higher earnings as well as increased other comprehensive income were the main drivers. On the next page we continue with the analysis of our Automotive segment.

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Year-on-year, Automotive increased sales in Q3 to €708 million. FX-adjusted growth came in at 5.2%. At the same time, global Light Vehicle production declined by minus 0.7%. So, in a contracting market environment, Rheinmetall Automotive has shown a very strong performance. The same applied to the result development. The operational result went up from €57 million to now €60 million. The operational margin rose from 8.3% to 8.5% in Q3 2018.

Operating free cash flow declined from the very positive previous year level of €81 million to €-2 million. Operating free cash flow was impacted by higher capex, cash-out for the aforementioned restructuring in France last year in an amount of €10-15 million and different timing of customer payments. However, we are expecting a positive catch-up effect in Q4 that will bring the operating free cash flow for the full year back to the lower end of our strategic guidance range of 2-4%.

Please turn now to page number 9 for the divisional view.

Mechatronics sales grew by €5 million to €387 million showing an operational growth of 2.7%. The division's result maintained its high operating margin level at around 10%. Growth was hampered by the continued decline of the Diesel market share, especially in Germany, where car registrations for Diesel cars fell below 30% of the market. We have indicated in our Q2 call that the second half of 2018 will be supported by new starts of production and these have already started to materialize with the majority still to come in Q4.

Hardparts grew by €19 million to now €251 million, again an operational growth of 10.6%, driven by the equipment sale for the production of non-LV pistons to a licensee in China from which we will generate future license income.

Aftermarket saw a decline in Middle Eastern and African markets, but new business in NAFTA and China, and profitability increased to now 9.8%

Let's now have a closer look at the regional sales development on page number 10.

While German sales declined in relative terms, they still grew slightly in absolute comparison. The rest of Europe saw a decrease in absolute and relative terms of 4%. All other regions with the exception of South America, did not see any major decline. China benefitted from the aforementioned equipment sale.

In the Non-Light Vehicle business, the vivid demand from our truck customers rose by 11% to €101 million. Products for smaller markets like large-bore pistons, pistons for special engines and continuous casting increased sales from €43 million to €55 million.

Please move now onto page number 11.

Our business development in China grew strongly against a negative market trend. Sales achieved an operational growth of 6.4% versus a market drop of minus 4.2% according to IHS. Start of production in China already left an encouraging footprint in Q3 and is expected to continue in Q4. This ramp-up situation still negatively influenced the result development in the current quarter. So the operational margin dropped from 7.9% in Q3 2017 to 7.0% in Q3 2018. In general, the slow Chinese market could or should benefit from the recently announced sales tax reduction.

[Page 12]

We have already seen the positive contribution of some customer ramp-ups in Q3 and we are expecting to see even more of this in the last quarter of 2018.

But the current market environment with persistent FX headwinds and a continued downward correction of FY 2018 market growth assumption to only 1.4% with the October IHS update, has led us to the conclusion that our FY 2018 reported growth guidance of 3-4% might be too challenging. And therefore we have decided to be more cautious and trim our guidance to a growth level of 2-3%.

On the other hand, we are confident to exceed our margin guidance of around 8.5%, as our 9-month profitability is already above that level.

Let's continue with Defence on page number 13.

Q3 closed with an announced record order intake driven by the Australian orders and confirming our position as a trusted supplier to the Australian land forces. Defence sales guidance always incorporated a heavily back-end loaded 2018 and after operational growth of almost 5% in Q3, Q4 will have to deliver the remainder. But I will come to this in a minute.

The segment's result was slightly below last year's due to a couple of reasons. I will present the details during the discussion of the divisional performance on the next page. The operating free cash flow developed in line with our efforts to supply Q4 and reflects the delayed order execution and the delayed customer's prepayment.

Let us now take a look at the divisional development on slide number 14.

In Q3, Weapon and Ammunition reported a decrease in sales of 21% to €196 million. Three main effects were responsible for this decline: The aforementioned explosion in South Africa, lower shipments due to pending export approvals and customer delays and persistent dry weather conditions prohibiting approval tests on our firing range in Unterlüß due to the potential fire hazard (as it has happened on the Bundeswehr testing site in Northern Germany).

The operating result in Weapon and Ammunition was cut by almost two thirds to €10 million due to the missing operating leverage corresponding with the sales reduction.

Electronic Solutions increased sales by 3% to €170 million and improved results from €6 million to €8 million. The earlier than expected realization of cost savings was a major contributor to the result improvement.

Vehicle Systems sales rose by €25 million to €395 million. Operational earnings expanded from €13 million to €30 million. High utilization rates and the phasing out of the Dutch Boxer contract were key to this improvement. We have made good progress on our supply chain issue and we are confident to fully resolve this by the year-end.

Moving on to page number 15 for the details of the order situation.

Vehicle Systems clearly drove the order intake in Q3, underlining the competitiveness of our vehicle portfolio: €2.1 billion for the Australian Boxer, €0.4 billion for the follow-on contract for Australian trucks and some €200 million for Fox Kits were the big tickets in this quarter. The backlog has now reached a new record level of almost €8.8 billion rising roughly 30% compared to last year.

In total, we are expecting between €600-700 billion of orders in the final quarter. Roughly the same amount we got in Q4 2017. This includes around €300-400 million of German orders compared to only €240 million in Q4 2017. Q4 2018 would hence account for roughly 40% of the total German orders in 2018 with an annual value of roughly €700-800 million after €1.6 billion in 2017. More is to come in 2019. The additionally required order entry to take us to our Q4 sales is basically on the same level as last year.

Moving on to page number 16 for details of the order backlog.

Thanks to the high order intake in Q3, the order backlog strengthened especially in our Vehicle Systems division. This is in line with our strategy to continuously increase the platform of vehicles as a catalyst for future business such as upgrades, overhauls and in case of tactical vehicles additional ammunition sales. Australia accounts for an impressive one third of our order backlog. Since German export regulation treats Australia as a NATO-equivalent nation, two thirds of our sales will be oriented to NATO regions.

Please now turn to page number 17.

Two issues came up in Q3 that are expected to have a strong impact on our topline development:

The effect from the explosion in South Africa is expected to adversely impact sales by up to €30 million in H2.

Even higher is the effect of the planned export of heavy trucks to a customer in the Middle East. Here we act as a prime for this order which includes the delivery of trucks and trailers; the latter coming from a sub-supplier. While we have already received the required export approval for the trucks, the sub-supplier is still waiting for an approval for his trailers, which precluded the execution of the entire order. In the current situation, getting the approval looks rather unlikely, putting the entire deal of up to €130 million in danger since our customer currently does not agree to partial delivery of the trucks only.

Defence made great progress in closing the sales gap that opened in Q1 during the course of the year. But given these recent developments we have to be realistic and therefore have to lower our full year sales expectations. The combined effect from both issues accounts for around €160 million or 5% of total sales. Additionally, adverse FX effects are a topic that negatively impact our sales development during the entire year.

Please turn now to page 18.

“2018 will be very backend-loaded.” This is a mantra you have heard from us during the entire year and we know that some of you are a little nervous about this.

With October sales in our books and a good visibility until the year end, we are confident to achieve our revised guidance. Each of the divisions forecasts additional sales of around €70-80 million compared to last year, with the majority of these sales in Electronics Solutions and Vehicle Systems coming from German orders we booked in last year. We expect the Q4 margin to exceed the previous year for the following reasons:

Weapon Ammunition is forecasting a higher level of pure ammunition business. Cost savings will be realized earlier than expected and efficiencies in our production process do come in at the higher level. Especially Vehicle Systems benefits from

better execution, lower than anticipated cost and improved price levels, all positively affecting the division's profitability.

Last but not least, join me on page number 19 for the summary of our guidance.

For Automotive we lower the sales growth guidance to 2-3%, which still includes the lower end of the original guidance range and reflects the negative IHS trend of only 1.4% growth for 2018. The FX adjusted growth for Automotive stands at 4.8%. However, we can confirm and even upgrade the margin guidance to slightly above 8.5%, bearing in mind the already achieved 8.8% after 9 months.

For the Defence segment, we think it is very clear that we have to lower the growth guidance for the full year to now 6-7% given the aforementioned special issues. By the way, adjusted for FX effects, the growth rate would be around 10%. We presented the drivers for our year-end rally and in consequence increased the margin by at least 0.5 percentage points to slightly above 7%.

And to put it in a nut shell, we are cautious regarding the topline, but we are confident on delivering our results. We have come to the end of my presentation and I am now looking forward to answering your questions.

00:21:36 Operator

Ladies and gentlemen, if you have a question, please press 9 and star on your telephone keypad. If you want to cancel your question, press 9 and star again. Please press 9 star now for your question. The first question comes from Sven Weier.

00:22:00 Sven Weier

Yes, thank you for taking my question and hello Mr. Merch.

I have a lot of questions for you, so maybe we can go through one by one. The first question relates to your client relationship to this MENA customer that you mentioned.

So first of all, I was wondering what the exposure to this customer is outside this truck contract? To what percent of this in sales is the amount? And I guess it's solely coming from outside of Germany.

And also what do you think about this customer's bids for the minority stake in your joint venture in South Africa?

That would be the first area of questions.

00:22:42 Helmut Merch

Because of the recent announcement coming this morning to the press, I do not want to comment on this. As you know, we have a 51% share in this company and if

a company out of Saudi Arabia wants to buy shares, we do not and cannot comment this morning.

The other part of your questions relates to business we are actually doing with a country out of Germany. And here some businesses are related to our plant in Italy and our plant in South Africa. And these businesses and these contracts are actually not being affected.

00:23:47 Sven Weier

Could you quantify how big that business is for you? Because that's more on a recurring basis, I guess.

00:23:53 Helmut Merch

I think we have a large ammunition contract being executed for a couple of years. The amount is in a dimension of lower triple digit, million each year

00:24:17 Sven Weier

And there's nothing else from Germany that you export except for the trucks. So that's the only business you have outside of Germany really.

00:24:25 Helmut Merch

That is the only business actually affected. These are the 110 heavy trucks and I explained that acting as a prime, we are now affected by the situation that our sub-supplier has not got the export approval until now.

00:24:47 Sven Weier

And regarding this minority stake have you also tried to buy this out and did the government not want to sell it? Or how should we look at that?

00:24:56 Helmut Merch

We acquired this 51% stake in 2009. We had a very close and good relation with Denel Company. And behind Denel is the South African state and therefore we actually do not want to comment on this issue.

00:25:20 Sven Weier

And the other question I had was just when I look at your backlog for delivery in the next year, you had €2.5 billion this time around. But you also had €2.5 billion in Q3 last year. So starting with that, that would actually imply only flat sales for Defence next year. But I guess your ambition is much greater than that. Is it still fair to assume that next year you should be round about at a mid-point between this year and the €4 billion goal you had for 2020? Is that still a fair assumption?

00:25:51 Helmut Merch

I beg you for your understanding. We will give full year guidance for our topline development early March next year. I would guess that we have still the chance in Q4 and also in H2 to get enough order intake to show also a good growth rate in 2019. And also the order backlog covering our expectation for further growth in 2020 and 2021 is still in good shape.

00:26:30 Sven Weier

Okay. Last question, really just housekeeping stuff: First of all, if you had to comment on the Mechatronics margin in Q3 which was quite a bit down year on year, and at the same time the Vehicle margin was quite strong. So, anything extraordinary going on in those two margins?

00:26:52 Helmut Merch

I think we discussed for a couple of quarters the continuous increase in margin in Mechatronics. We reached I guess peak level around 10% plus. We had not such high growth in Q3 and therefore we have shown still a nice operating margin of 9.8%. I think we also got some price pressure from OEMs, but I guess this high margin in Mechatronics could be a sustainable one in the next couple of quarters. But I think we do not mind whether we've made 10.5 or 9.8.

00:27:45 Sven Weier

And on Vehicles?

00:27:47 Helmut Merch

Regarding the division Vehicle Systems I tried to explain the situation in Q2. We had a positive effect when we made very deep reviews in two of our major programs and we could release some of our risk buffer. And therefore we have a good operational performance and actually we see that we have very good effect from high utilization rate. And I think to give you only an example, we discussed several times the bad impact from legacy projects like the Dutch Boxer program which we have manufactured in Netherlands. We restructured Netherlands last year, now we put new orders for Boxer Germany and Boxer Lithuania in the factory. And here we had a significant turnaround and therefore you see that the fading out of bad contracts replaced by good contracts will have a significant positive impact on the margin improvement, especially in Vehicle Systems.

00:29:13 Sven Weier

Thank you, Mr. Merch.

00:29:20 Operator

The next question comes from Sebastian Growe.

00:29:25 Sebastian Growe

Yes, good morning everybody. Three questions overall.

The first one is on the bridge again for 2019 to a certain extent and the revised guidance where you took out around €150 million. €160 is what you mentioned I believe on the topline. Is this something that we could add back for 2019? Or how should we really think about those very sort of lost, temporarily lost revenues in '18 compared to 2019? Maybe take them one by one. I think that would be...

00:29:54 Helmut Merch

Yes this is a good proposal. So the €30 million we are actually losing because of the incident in South Africa, this is very likely to be caught up during 2019 because we are looking actually for compensation and for different plants in which we can produce this material.

The question regarding export approval is a little bit more difficult. We have somewhat of a tension regarding especially this export thing. Here we have to look what is the action or the answer of the German government. Up to now as I elaborated, we have the export approval for the trucks and we have to work, or the sub-supplier has to work for getting his approval. And then we will see whether we are able to ship all the stuff during 2019. I cannot promise. We will work very hard and we will also support our sub-supplier. But this will be an open issue and I'll give you updates during next year.

00:31:21 Sebastian Growe

Okay very clear. And the next one, and you elaborated already on the improved mix situation around Vehicle Systems and the restructuring of the Boxer Netherlands plant. When we think about the Vehicle Systems order intake more recently, and you said in your prepared remarks that these are also coming with Weapon Ammunition business, can we get some more color on where you just see structurally really the order backlog quality going? Given that you are I think actively selling more especially of the higher margin pieces i.e., Weapon Ammunition through, then also the Vehicle Systems orders you received recently.

00:32:00 Helmut Merch

Here I can repeat one statement I gave in one of the previous calls. We actually see a continued improvement of our price level in the fresh order intake. And therefore we are confident to show more EBIT improvement to come in the next years. And the last big order, which will fade out at the end of 2020 with fairly low margin is the German Puma contract. And this contract is completely replaced by new orders with good margins. And therefore Vehicle Systems will be one of the drivers for the topline and also for the bottom line.

00:32:59 Sebastian Growe

Okay, helpful. And then finally on Auto, when I look at the 9-month trend on the margin side I mean, then we see that you are running some some 10 bps perhaps compared to the prior year. And looking then also at the guidance, is there anything that we should have in mind when it comes to mix effects, etc. in quarter four, so why the margin should actually be down in quarter 4 '18 compared to quarter 4 '17?

And the second question on Automotive I do have is on the Diesel impact. You mentioned before that obviously the Diesel registrations have slumped quite significantly. I think we were used to see that business growing at least 5% on average or so. Given where we stand really with all these Diesel grade issues, can you give us an idea at least where you think that the structural growth of Mechatronics will ultimately settle after eventually what has been a very difficult year 2018?

00:33:55 Helmut Merch

I think Mechatronics will still benefit from the continued demand for products getting emissions and fuel consumptions down. So this trend is a sustainable one and also the pressure on the Diesel will, mid-term and long-term, give a positive effect to the Mechatronics business.

The mix effect which you have asked, yes, here we will have a slight impact because the core Diesel products have a strong margin and we see a declining sales in our Diesel business for the first nine months, roughly 8% or €50 million. Therefore there is some slippage in the margin, but actually we are compensating more or less the lower Diesel sales for Light Vehicle cars with Diesel products we are selling to truck customers. So therefore we have no real impact on the topline but some impact on the profit margin.

And looking to your first question regarding Q4 expectations regarding EBIT. If you're looking at our revised and updated EBIT margin guidance, this will imply more or less the same absolute EBIT contribution in Q4 compared to Q4 2017. It will be very much dependent on what we will see in November and December. In case November and December will be stable months, then we have also a chance to reach Q4 '17 margin. But anyhow, we have to be a little bit cautious, as you know the market is nervous, and there are a lot of uncertainties.

00:36:22 Sebastian Growe

Okay, very helpful. Thank you.

00:36:28 Operator

The next question comes from Christoph Laskawi.

00:36:33 Christoph Laskawi

Good morning. Thank you for taking my question. I'd like to go one by one as well, if okay with you. The first one will be on Defence. Small questions only: You talked about the customer approval delays in Weapon and Ammunition because testing is basically ... or the testing range is not functional. Is there any visibility on the potential timing when those finally come in and the testing sites are restored again? Or is that very uncertain? I would expect it probably in H1 next year, is that fair?

00:37:11 Helmut Merch

No, no. We already started our activities. The sun is no longer burning like hell as you know, so we picked up our activities at the testing range. We will catch up. All this we delayed in Q3, we will catch up in Q4

00:37:34 Christoph Laskawi

Okay thanks. And is there any potential timeline that the German government indicated for the final approval on the trailers? Or is that ...

00:37:43 Helmut Merch

Unfortunately not. You also read the media and the press, what is going on regarding export approval concerning some MENA or Middle East countries. It is actually unpredictable.

00:38:04 Christoph Laskawi

Yes, especially when you read the press statements. I guess it's quite tough currently on that side.

Moving to Autos, you actually had I think a very decent quarter in Q3 also looking at the competition with the outperformance that you've shown in one of the few suppliers that actually showed a marginal improvement versus a couple of others that had issues to show any improvement whatsoever. Looking at Q4 and what's ahead, you are working with still a global production growth. Conti now pointed to the production being down 2% to 3% in Q4 which is what some market participants also point to.

Still there was also the case in Q3 and you managed to outperform quite nicely, even stripping out the tooling sales. Could we expect the outperformance level adjusted for the tooling to be roughly the same in Q4 again? You pointed to other ramp-ups that should help and also as China is largely not consolidated and done through joint ventures, should we expect that to continue also in Q4?

00:39:15 Helmut Merch

Yes. I think it is a very easy calculation. Looking at our guidance of 2% up to 3% for the full year, this guidance implied that we are looking for a growth in Q4 of roughly

3.5% compared to last year. And if we match this with the expectations according to IHS, this will again be a quarter in which we will outperform IHS figures.

00:39:54 Christoph Laskawi

Correct. I was just referencing also that Conti is now expecting and I think other market participants as well production to fall. And I think, even if that is the case in Q4, you could still decently outperform thanks to the ramp-ups.

00:40:08 Helmut Merch

Exactly. And this will accelerate. I tried to explain, we started already in Q3. This will accelerate in Q4 and by the way, we had a good start in Q4 with October and therefore we're actually quite confident to deliver on the revised guidance.

00:40:32 Christoph Laskawi

That is very encouraging. Thank you. And a more specific question on your China exposure in Autos. Could you give us a comment on is that more mass market or premium related? And how much of that will be truck business?

00:40:51 Helmut Merch

So the majority of the sales is dependent on the mass market, but anyhow we have also quite nice shares with premium cars. But the mass is done especially what we are doing on the Hardparts side is done with Volkswagen and GM. So they are more or less the mass market. But as you know, with our Mechatronics products, we are serving to a much larger percentage local Chinese OEMs. So, to make it more clear, our portfolio is widely spread, we are able to move along on our path regarding Q3.

00:41:51 Christoph Laskawi

Excellent. Thanks a lot.

00:41:58 Operator

There are no more questions in the queue right now. So just as a reminder, if you have a question, please press 9 and star on your telephone keypad.

00:42:13 Helmut Merch

No more questions?

00:42:15 Operator

No.

00:42:16 Helmut Merch

So before I close the call, some final remarks from my side, ladies and gentlemen: Rheinmetall is fully on track to achieve a very healthy 2018 with a record level in order intake, sales and earnings.

In Automotive, we are confident in the delivery of the fourth quarter and long-term, the business is well set up to benefit from the positive trends for cleaner and more efficient mobility.

Defence is well on course to accomplish further margin improvement and the prospects of a very positive market environment continue.

Ladies and Gentlemen, thank you very much for your kind attention and have a good day.