

Rheinmetall AG
Investor Relations
Conference Call Q3 2017
Transcript



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Agenda

	Contribution	Course	Duration (min)
	Presentation - Begin	00:00:22	14:33
	Presentation - End	00:14:55	
	Questions:		
1	Sven Weier, UBS AG	00:15:33	3:04
2	Sebastian Growe, Commerzbank	00:18:37	7:53
3	Florian Treisch, MainFirst	00:26:30	4:27
4	Alexander Hauenstein, DZ Bank	00:30:57	7:44
5	Christoph Laskawi, Deutsche Bank	00:38:41	2:19
	End	00:41:00	

Rheinmetall AG Conference Call

00:00:01 Operator

Ladies and gentlemen, welcome to the Rheinmetall AG conference call regarding the Q3 results 2017. 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 hand the floor over to Mr. Helmut Merch.

00:00:22 Helmut Merch

Ladies and Gentlemen, welcome to our Q3 earnings call of Rheinmetall Group and thank you all for joining us.

Let me start with a brief introduction to our Q3 performance and then you will have the opportunity to ask your questions. Before I start, I would like to draw your attention to the safe harbor statement on the following page.

Let me begin with a highlight of the third quarter on page number 3. We continue to see a positive business momentum in both segments which translates into a sales growth on group level of 5% and amounts to total sales of €1,366 million in Q3. On the back of this development, operating results went up by €18 million to now €97 million.

Q3 operating free cash flow experienced a decline of €31 m compared to last year, caused by working capital buildup. As a measure to further optimize Hardparts' global network, we have decided to close our pistons production in France, impacting EBIT with €22 million. I will touch on this issue in a couple of minutes. Last but not least, we are happy to communicate that we affirm our guidance for the full year.

As you can see on slide no. 4, sales in Q3 grew by 5%. This figure is lower than the 7% growth in H1 2017, but fully in line with our expectation for H2. Our operating margin gained 100 basis points and achieved 7.1%. The absolute operating result went up by 23% and reached €97 million as already mentioned.

Let me now continue with slide number 5. Operating free cash flow declined by €31 million caused by additional working capital requirements of Defence. Earnings per share on an operating basis for the third quarter would have reached €1.18 cent. As the restructuring in Hardparts represents an impact of €0.35 cent, reported EPS amounts to €0.83 cent after €0.97 in Q3 2016. Year-to-date EPS of €2.40 compared to €2.22 in 2016. Headcount in capacities slightly moved up by 3% on the improved business level in both segments.

Page number 6 presents details on our net debt position and the development of the equity ratio. Our financial situation continues to develop favorable and we can report a reduction of net debt by €203 million to now

€242 million. Equity ratio advanced by 500 basis points to 31% which underscores our solid financial structure.

Please turn now to page number 7 to have a closer look at the Q3 highlights of the Automotive business. Automotive sales growth has beaten global light vehicle production growth in Q3 and reached €684 million or a plus of 6.4%. Currency-adjusted sales grew even higher by 7.3%. More important was the operating result improvement of 12% to €57 million, which translates into an operating margin of 8.3%.

Reported EBIT accounted for €35 million and was impacted by minus €22 million because of our restructuring measure in France. We are convinced that the business benefits from this measure structurally and that we will see improved quality of earnings of our Hardparts business in the future. Operating free cash flow improved strongly in Automotive from €47 million to €81 million in Q3. Now, please switch to page number 8.

Higher sales and improved margins underscore the good operational performance of our Automotive business. The already mentioned restructuring measures in France have been booked and they are regarded in our Q3 results. Operating free cash flow showed an increase to €81 million as already mentioned and this reflects mainly improved working capital. The restructuring measures have not been cash-effective in Q3.

On page 9, we present the divisional break down for Automotive. Mechatronics sales once again benefited from a lively demand for our fuel optimization products. Demand for our emission reduction portfolio remained on a high level. Positive operational leverage and favorable portfolio effects took margins to double digits.

Hardparts enjoyed a continuation of recovery in the Large Bore Pistons business and an overall good demand for light vehicle pistons in Europe. This increased operating results from €11 to €13 million in Q3. The at-equity-contribution of the Hardparts joint ventures with our Chinese partners accounted for €5 million, after €6 million in last year's Q3.

The Aftermarket business reported an increase of 16% lifting sales to €95 million. A continued pickup of demand in Eastern Europe was the main driver. Operational margin for the quarter was now 9.5%.

On page number 10 we compare our regional sales performance with IHS global light vehicle production volume development. Global light vehicle production grew by 2.2% and Rheinmetall Automotive exceeded that growth by more than 4 percentage points and achieved a rate of 6.4%. In some regions like China, North America and the Rest of the World we see an even more striking discrepancy between the market and our growth development.

Please turn now to page number 11. Concerning China I can report the following: Light vehicle production in the largest car market of the world contracted slightly in Q3 by -0.4%. Nevertheless, our Chinese entities - the joint ventures and our wholly-owned companies - grew by 7% in local currency. This confirms the high demand for our products. They were also able to turn this growth into profits: while sales grew by 128 million Yuan, the operating result rose by 12 million Yuan.

The joint ventures outperformed the market with a growth rate of 6% in local currency. The two Hardparts JVs contributed - by far - most of this growth, but we see also a good progress in sales and earnings of our pumps JV which is still small. Among the Wholly Foreign-Owned Enterprises, I would like to highlight the dynamic development of Pierburg China which is linked to the high demand for our emission products.

In the Q3 comparison, the Chinese currency Yuan lost 5% value against the Euro. Therefore, growth rates reported in Euro do not reflect the growth generated in that country.

Already at our 2016 Capital Markets Day and in our full year guidance from March this year, we have pointed out the necessity for further cost optimization in the Hardparts division, especially concerning labor intensive production in high-cost regions. After intensive, but consensual discussions with the local employee representatives, we reached an agreement that stipulates the closure of the production facility in Thionville in France until H2 2018. Cash effect of around €17 million for a severance package and site clean-up is expected for 2018. The impairment effect amounts to around €5 million. We expect to see an earnings improvement of around €10 million annually from 2019 onwards. With this, I would like to conclude my remarks on Automotive and take you to the highlights of our Defence segment on page 13.

Order intake benefited strongly from German orders and we are closing in on our goal to achieve a book-to-bill ratio above 1 for the full year. Sales increased by 3% to €682 million. Operating result surged to €46 million, an increase of 53%. And this pushed the quarter's margin from 4.5% to 6.7% in the last quarter. For the quarterly comparison, please turn to page number 14.

Order intake grew strongly compared to last year and achieved €870 million, driven by German orders of roughly €460 million. Sales increased as expected, growing slightly by 3%. Operating results continue to show the positive trend of the last quarters, year to date results increased by 87% to now €60 million. Cash flow was affected by working capital build-up due to the payment of a receivable in a meaningful amount that slipped from September to October and therefore could not be regarded in Q3.

Let us now have a look at the divisional development on slide number 15. Weapon and Ammunition was the quarter's growth driver after we have seen in Q2 a slight decline contributing €21 million additional sales and a good margin of around 11%. Electronic Solutions again saw soft sales in Q3, but was able to stabilize results. Vehicle Systems reported higher sales, however a little less dynamic, but results benefit from good utilizations levels and favorable product mix.

Please join me to the presentation of the order intake on page number 16. Order intake in Q3 saw growth of 52% compared to last year and accounts for €870 million. This includes the already mentioned key German orders with a total of about €460 million, including trucks, additional Puma equipment and Leopard upgrade program. Q3 also saw the first order for tank ammunition with a value of €38 million and last week, we just reported a new order for 10,000 rounds tank training ammo with a net value of €20 million. Both orders fall under the new framework agreement with the German army. Book-to-bill ratio trends towards our full-year target of above 1. Please turn the page to slide 18.

Before I conclude the chapter on Defence, I would like to shed some additional light on the German truck order. This order represents a lighthouse project for Rheinmetall Defence. The framework agreement covers a total order size of around 2.200 trucks of which the first 558 will be delivered until the end of 2021 or earlier. The full agreement has a net value of €760 million. This is an important contract to keep the Vienna plant on a very high utilization level for the next years.

Finally, a word on our full year guidance on page number 18: Based on what we can see coming until year end, we now specify our guidance on segment and group level: In Automotive sales are expected to approach the upper end of our growth guidance and we confirm our operational margin of around 8.4%.

Defence sales will be more at the lower end of our guidance range, but we expect operating margins to perform at the upper end of our guidance band. Therefore group sales are expected to grow around 6% and we are more optimistic regarding the operating margin. Therefore we raise our guidance to slightly above 6.5% from around 6.5%.

Last but not least, I would like to remind you of our Capital Markets Day 2017, this year in Bremen on November 21st and 22nd. And I am happy and I'm looking forward to seeing you there!

Thank you very much for joining the call and now I am available to answer your questions!

00:14:58 Operator

Ladies and gentlemen, if you would like to ask a question, please press 9 and the star key on your telephone keypad. In case you wish to cancel your request, please press 9 and star again. So please press 9 and star to state your questions.

And the first questioner is Sven Weier from UBS. Please Mr. Weier, it's your turn now.

00:15:33 Sven Weier

Yes, thank you. Good afternoon, Mr. Merch. Several questions which are all related to the Defence business. First one, I brought on the working capital where you mentioned there was a sizable impact from a receivable, I was just wondering if you could quantify the impact a bit further here. The second question is on your remarks to book-to-bill. So is it fair to assume that your Q4 order intake in the Defence business could again be north of one billion as you had it in Q2 when you look at your current pipeline?

And the third and last question is I think at the Capital Markets Day last year you rightly said that 17 would be a transition year, so single digit growth, but that 18 could be a year of probably low double digit growth again for the Defence business. Would you already re-confirm that at this point? Or should we wait until the CMD in two weeks? Thank you.

00:16:31 Helmut Merch

Okay, thank you Mr. Weier for your questions. Starting with the first one, so the amount of the payment slipped from end of September to beginning of October was around €80 million. The book-to-bill ratio we want to achieve is above one. And therefore it is reasonable to assume an order intake of roughly €1 billion for the Q4. And regarding our estimation for growth in Defence of next year, I take the opportunity to confirm our estimation and I give you a slight indication.

If you look at our order backlog on page number 16 which we already have at the end of September for the next year. And this is an amount of €2.5 million and last year at the same point of time, end of September 2016, we had an order backlog for the following year which was €400 million lower. Therefore this is a strong indication of a higher growth in 2018 compared to 2017. And this also confirms our estimation of a double digit growth target on the top line for the Defence next year

00:18:09 Sven Weier

Thank you and it's probably fair to assume that on the back of that, we'll also see further impact of your let's say more selectivity on the orders, i.e., also better margins.

00:18:21 Helmut Merch

That is what we are trying every day and week.

00:18:27 Sven Weier

That's clear. Thank you Mr. Merch.

00:18:29 Helmut Merch

Welcome.

00:18:32 Operator

Next up is Sebastian Growe from Commerzbank. Over to you Mr. Growe.

00:18:37 Sebastian Growe

Yes good afternoon everybody and thanks for taking my questions. Three over all, let's start with Defence first and just to follow-up Defence questions before. In the past I think you have usually in the September quarter a coverage ratio for the next year of something like almost 70%. Would you agree that this math should also work out fine for the year 2018? And if so, then it's just €3.6 billion or so in terms of revenues for the next year. Or does this sound outrageous to you for the time being?

Then moving on to Auto, the first question on Mechatronics, you said that fuel optimization has been the key driver again, also for the very good growth in the quarter three. Based on the negotiations that you have with the OEM customers, can you give us a sense for the midterm outlook that you would see in the Mechatronics business? And also shed some light if you do believe that there's any substantial change to mix expected? Or should we pencil in something like clearly above 10% margin for the Mechatronics business owing to that all the techniques that you're currently enjoying?

And then lastly on Aftermarket, you've been pointing here to the recovery in Eastern Europe as the key driver for the growth in that business unit. How should we think about the basic fact? And then when is sort of a normal growth rate eventually for Aftermarket going forward, especially when considering that this should sooner or later clearly follow the much increased revenue pull in Mechatronics which is carrying higher ASPs than is the case for the Hardparts business. Thank you.

00:20:12 Helmut Merch

I thank you, Mr. Growe, for your questions. So starting also with the Defence question, I said that today we have €400 million higher order backlog covering our estimations for next year's topline growth. I don't want to guide you explicitly on absolute figures. So the real target for 2018 we will communicate in March next year. But I already said that we have strong indications for what we have already said last year during Capital Markets Day that 2018 will be another year of double digit growth.

The midterm outlook for our Mechatronics business is for the time being, it's still positive and I think we are still benefitting from the demand of the OEM, reducing emission and reducing fuel. I think there will be a change regarding the diesel share of our business and this is not really stopping our growth actually. But if we will see a further and stronger decline, this could

be of an impact in our Mechatronics business. But we, on the other hand, see a strong demand for our gasoline product. And therefore we see that we will stick to our midterm guidance that we want to outperform global car market growth by at least 150/200 basis points and also, our view on the margin development in Mechatronics is, for the time being, is not ... eingetrübt [weakened].

And last question for the Aftermarket, I think you're right. We see a strong growth after we have seen a more or less a flat development in 2016, and now the markets are recovering and I think we should assume for a midterm growth in this business a rate of 5 to 6%.

00:23:08 Sebastian Growe

Okay, thank you and if I just may ask that quick follow-up on the order pipeline in Defence overall. Can you just walk us through what you see currently in the market and especially eventually also give us a sort of indication where you stand especially on the big programs not least in the in Australia for Land 400 etc. and how the tests are going etc.

00:23:30 Helmut Merch

Yes picking up Land 400 project, so tests are finalized and we were requested to give our final and best offer for this project. And now the relevant authorities are in a process of evaluating the two offers. One is from our competitor BAE and ours, and as I mentioned in the last calls, this will take time. Probably we got some first indication in Q1 what will happen so far. But now it is more or less in the hands of the customer.

And the path of approval is still valid. So the order will be placed during H1 of next year. So in our pipeline for the running quarter, but also for Q1, are several programs for air defence but also we have a bunch of medium size and small order which could be finally closed within weapon and ammunition. And we are currently negotiating a follow on contract with Algeria. As you know we have booked three years ago a contract with Algeria for kits to assemble the Fox down in Algeria and here actually we are looking for a medium sized follow-on contract.

Regarding the English programs, upgrade program for the Challenger and the so-called MIV program, Mechanized Infantry Vehicle, here you could have read something in the press. The British army is keen to acquire an armored transportation vehicle. But I think the actual Brexit discussion is something which is above the whole arena and I think we do not expect a final outcome before the end of 2018.

00:26:16 Sebastian Growe

Okay very good. Thank you.

00:26:18 Helmut Merch

Welcome.

00:26:22 Operator

And the next questioner is Florian Treisch from MainFirst bank. May we have your questions please.

00:26:30 Florian Treisch

Yes. Hi gentlemen.

00:26:31 Helmut Merch

Hi.

00:26:32 Florian Treisch

After all the positive questions, I try to find at least some not so positive part of the story, but admittedly not very large ones. And the one point is Vehicle Systems; your profitability is down quarter on quarter despite higher revenues, is that simply a mixed effect? The one question.

The second is, Automotive, if I'm right 8.7% after nine months implied Q4 would be clearly below 8% so 7.7 or so. Is there a good reason to be that conservative to come to this end, you guide 8.4%?

And the last one is on Hardparts. The European joint venture posted a negative EBIT, I believe one million negative. Is there a particular reason for it? Or are these simply related to R&D investments in for example battery housing modules etcetera?

00:27:20 Helmut Merch

Starting with the last question, Mr. Treisch, yes it is a specific reason regarding our German joint venture. In Neckarsulm here we have some planned and some also some unexpected ramp-up cost for a new product. It is a structural part for an OEM and here we have to some extent underestimated the ramp-up curve, and this led to some small losses. We are actually in the process to improve the production. And therefore we expect that this impact will decline to a certain extent during the next couple of quarters. So therefore we expect for the next year a slight recovery for this entity.

Coming to your questions regarding margin, I think first of all, we are very happy to be able to perform with 8.7% after nine months, and traditionally we see the Q4 as the weakest quarter in the year and is highly dependent on the last decisions of the OEMs regarding the sales in December. And therefore if I would now know the year's end figures, we would have a year's end report discussion. But we have the Q3 discussion and therefore please give us some room for the next two months. And if we are able to perform slightly better, then I think we also would be very happy to communicate this.

Coming to the first questions regarding your remark of the operating margin in the Vehicle division, I cannot follow that we are weak. I think in the selective Q2 we had an operating margin of 4% roughly and now we are on 3.6%. That is a slight decline, but is in our expectation. It is highly dependent of the portfolio mix in the various quarters.

We are still on a good track regarding performance in Q4 and therefore we underline that the Vehicle Systems have made the turnaround and will be a good contributor to our EBIT performance in Defence and on group level.

00:30:38 Florian Treisch

Thank you very much. Yes, looking forward to meeting you at the Capital Market Days.

00:30:42 Helmut Merch

Yes I'm happy to see you.

00:30:48 Operator

The next questioner is Alexander Hauenstein from DZ Bank.

00:30:57 Alexander Hauenstein

Hello this is Alex Hauenstein, DZ Bank. I've got a few questions please. First of all, with regard to the Hardparts restructuring, is there some more to do here? Or could you give us some color or what's going to be potentially on your focus or agenda coming into the next year potentially? Or is it more or less done now? That would be my first question.

The second question is in Defence; new government is currently finding a way how to cooperate with the different parties. What do you expect to be the first issues that they're going to tackle? Or what should they tackle first? And maybe you could share some views here, what could be a very good outcome overall from these coalition talks, or what could be a worst case potentially of a so-called Jamaica coalition?

And lastly with regard to an update of the use of cash, I was wondering whether you could share some views here on how to spend the cash going forward. Is it more investing into the Mechatronics part? Is it some M&A coming up in certain activities? Maybe you could share some views here. And last question, also with regard to cash, do you intend to put some more money into the CTA? And if so, probably at the end of the year is that right to assume? Thank you.

00:32:22 Helmut Merch

Yes, thank you Mr. Hauenstein for your questions. Starting with your first one, I guess that I tried to explain in our guidance for the full year and also during our Capital Market Day last year, we give some indication, we give some light what we see what is needed within Hardparts. Now with a decision to close the France site, we have more or less all production of light vehicle pistons in low labor cost areas, we have left a small steel pistons production line in Germany, but here we have a different competition situation. But I think for the time being we should assume that the closure of France only for the piston plant... We have also another plant in France for Mechatronics which is doing pretty well. And therefore for the time being: No we have not a similar restructuring case in mind or we do not see a similar case during 2018.

Looking to your second questions regarding possible speculation on political issues and matters, I would not like for the time being to be part of a speculation what will be the outcome of the Sondierungsgespräche [exploratory discussions] in Berlin and what will not come. So I think we should or you should raise the question once again if we see hopefully in December or January a new government. The worst case I would assume, but that is my personal opinion, is a new election because then the whole story will go on, and therefore all the other stuff I think we should address if we have a better view on what will be the outcome of the political discussions in Berlin.

Last questions regarding cash; because of the fact that Mechatronics is not only on the topline, but also on the bottom line, the driver for profitability, we will invest in Mechatronics for future products. For products regarding e-mobility, I think we have raised a lot of different issues and therefore there will be money to go into R&D and also to some extent into capex.

On the other hand, yes we are also looking for opportunistic M&A transaction, but the cases for Defence are very limited. We will not invest in North America. We are looking around Europe, but more or less the most of the possible targets have a governmental shareholder structure, and therefore there is limited access.

And on the other hand also we are screening the market for opportunistic targets in the Mechatronic business. But I think we are very enthusiastic and proud that we are able to drive most business via organic growth so we are not desperate to buy any target, but in case there would be a lucky punch, we are I think as you know regarding our financial structure, we are prepared.

And regarding an additional funding of the CTA, yes we have made a fundamental decision regarding CTA funding two years ago. We had two tranches we have already funded, each with €30 million, and I would assume that at least €30 million we are going to fund during the next couple of months. I do not know whether it is the case still before year's end. But I think in Q1, I could imagine that we will have another funding.

00:37:17 Alexander Hauenstein

Okay thank you and maybe a quick follow on, on the Mechatronic investments going forward. Could you give us a certain idea of the payback time and the let's say overall amount you want to spend here? Maybe with a certain timeframe for R&D and for Capex, is that possible? Just to get a rough feeling how long it takes until it materializes with a major part into your P&L now.

00:37:43 Helmut Merch

I think more or less we are aiming to make investments which have a payoff of roughly three years or below.

00:37:59 Alexander Hauenstein

The amount you want to spend here. Can you describe it or give a rough idea?

00:38:05 Helmut Merch

Yes the rough idea is that we spend between 5 to 6% in terms of sales in the Auto business and actually we are spending slightly more in Mechatronics. This went up to 7% and we have reduced our R&D expenses in Hardparts slightly.

00:38:31 Alexander Hauenstein

Okay. Thank you very much.

00:38:33 Helmut Merch

Welcome.

00:38:36 Operator

And next up is Christoph Laskawi from Deutsche Bank.

00:38:41 Christoph Laskawi

Good afternoon. Only two brief questions from my side. The first one would be on the restructuring. You guide for €10 million earnings improvement starting in 2019. Is that a net or gross number? Do you need to hire additional people somewhere else where you shift volumes or can you cover that fairly easily?

And second question would be on margin differences between diesel and gasoline product. You commented that the diesel share of revenues has actually fallen and your margins are doing pretty well. So my question would be is gasoline actually more profitable for you?

And thinking about further declines in diesel shares, is it probably the case that you see, well, less topline growth but an improving margin just thanks to the mix effect or ...?

00:39:28 Helmut Merch

Okay different questions. So the first one, here we are aiming to realize a positive net impact of €10 million from 2019 onward. And more or less gasoline is slightly more profitable compared to diesel. But on the other hand, what we have to state, despite the decline of diesel share in Germany, overall we have a slight growth in our diesel-related products compared to last year. We had a flat development in Q3. So we are strongly benefitting also from this shift. But for the time being, I would not assume a further improvement in the margin of Mechatronics. We have reached a very high level also due to some positive impacts from the market and I would not assume that we have room to move to the blue sky.

00:40:43 Christoph Laskawi

Okay very clear. Thank you.

00:40:48 Operator

If you have any questions, please press 9 and star.

Mr. Merch, there are no further questions.

00:41:00 Helmut Merch

Thank you for listening and for joining the call. Have a good day and I hope I see some of you guys in November in Bremen to join us in our Capital Market Days. Thank you for today. Bye-bye.