Rheinmetall AG
Investor Relations
Conference Call Q3 2020
Transcript

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Rheinmetall AG Conference Call

00:00:01 Operator

Hello, ladies and gentlemen and welcome to the Rheinmetall AG conference call regarding the Q3 results 2020. 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.

[0:00:24] Helmut Merch

Thank you, Karin, for your introduction. Good morning everyone, I hope you are staying safe and thank you for joining our Q3 earnings call. I will first walk you through the Q3 results and then you will be given the opportunity to ask your questions. Please be reminded of our legal disclaimer on the following page.

And now let me start with our highlights on page no. three. Rheinmetall has so far coped pretty well with the crisis. Hygienic precautions helped to keep our employees safe. All plants are up and running and supply chains are still robust. However, we are now preparing for a second wave: We lately ran a hygiene awareness campaign and have stepped up internal precautions such as the return to more mobile work. Our dialog with suppliers and customers has been intensified to lower the risk from surprise disruptions of the supply chain. The operational performance in Q3 was marked by the recovery in our Automotive segment and the strong margin performance of our Defence business, well reflected in the KPI improvement.

Please turn to page number four. Reported sales declined by 6.6% to roughly EUR1.4b in the third quarter. Adjusted for FX effects, the decline was only 4.8%. The operating result was operationally a little lighter but rose on the back of slightly favorable FX effect to EUR101m and the operating margin improved to 7.3%. Special effects accounted for EUR35m, including the restructuring charge of EUR40m in Automotive and a net support of EUR5m in Defence. Reported earnings per share declined by 23% to EUR1.03. If adjusted for the special items in Q3, earnings per share would have been stable at EUR1.33.

Please turn now to page number five. Q3 2020 reported the best cash flow of a third quarter in the last five years. The operating free cash flow improved by EUR168m to EUR41m in the third quarter. The positive development was largely driven by the reduction of our working capital, continued strict capex management in Auto and the absence of CTA funding in Auto. In addition, the posting of the restructuring provision included EUR40m for the Automotive realignment and additional EUR5m for Defence, which were both cash neutral. On page number six, I will explain in more detail our capex outlook for the year.

The very different business development of the two segments is as well reflected in our capex management. While Automotive was able to reduce capex by 37% year to date and is well on track to achieve the full year savings target of around minus 30%, Defence had to support the growing business adequately.

The biggest increase of the Defence budget resulted from the capitalization of the lease agreement for the new MilVehCoE site in Australia. With the inauguration in Q3, EUR51m were accounted for in line with IFRS 16 reporting, and therefore did not impact operating free cash flow. Projects, like the Land 400 and the new family of future tactical trucks are responsible for the increase of our capitalized development cost. Total capitalized development cost year to date increased by EUR30m compared to last year.

Please turn now to page no. seven. The Moody's September report confirmed our financial strength and liquidity. After the impairment charge in Q2, our equity now slightly improved to roughly EUR1.9b at the end of Q3 and the equity ratio remained stable slightly above 26%. Net financial debt sequentially improved and was EUR89m better than the corresponding Q3 2019 figure at EUR571m. Net financial debt to EBITDA ratio was reported at 0.91times. There is no material maturity for outstanding debt in 2020 and 2021. Our liquidity reserves including cash and undrawn credit lines total to almost EUR1.4b. Join me on page eight for the summary of the Automotive performance.

The Automotive market environment continuously improved from July to September. Our FX adjusted sales development of minus 9.8% was below than the regionally adjusted IHS growth of minus 8.8%. The weakness in our non-LV business persisted. The operating result is still significantly below last year's level, but clearly recovered since Q2. Improving volumes in combination with our strict cost management helped to lift the operating result to EUR29m or a positive margin of 5.1% after 6.5% last year. Cost savings still include substantial support from short-time work. The at equity result contribution almost fully recovered to last year's level.

We already preannounced the restructuring charges of EUR40m in the Q2 call. So far, everything develops according to plan. Restructuring measures have been initiated, cash outs are expected to materialize over the years until 2022, mostly for severance payments and site shutdown cost. Savings are expected to ramp up from at least EUR20m in 2021 to the full amount of around EUR40m per annum in 2023.

Compared to last year, we were able to increase the operating free cash flow by EUR43m and accelerate the cash to sales ratio to 8.6%. The CTA funding of EUR15m in Q3 19 and an almost 50% lower capex in Q3 20 as well as the restructuring provisions of EUR40m which are cash neutral were the biggest contributors to this improvement.

On page nine, we are comparing reported monthly sales development with IHS monthly production development. The pandemic hit us like a tidal wave at the end of the first quarter and we could not adjust our cost base quickly enough. But with our fast acting cost cutting measures that started in Q2 and the recovery of the market in Q3, we were able to improve our operating leverage from 40% in Q1 to now 15% in Q3.

While volatility is now less of an issue, visibility has not increased significantly beyond our four weeks horizon. The market is now a little nervous regarding the outlook for the fourth quarter, but October was the first month with a positive sales development for our Automotive segment compared to last year. We saw an increase of 0.8% on reported sales or a FX adjusted growth of 4.7%. With the recent lockdown in Germany or light lockdown in Germany and many other countries, we now need to observe very closely how markets will react in the remaining two months.

Please move on to page number ten. While Aftermarket already returned to the growth path, Mechatronics and Hardparts still faced declining sales, however the latter much worse than the former due to the very negative market environment for pistons, in particular the large bore piston business. Here, demand for railroad engines and off road equipment was down significantly, due to low oil prices and freight rates. Strict cost management supported operating results, but this was not sufficient for Hardparts to return to positive figures despite at-equity results of roughly EUR6m being basically on last year's level. Aftermarket saw a strong sales recovery in most markets but also strong negative FX-headwinds especially from Brazil and Turkey. The operating result was supported by a favorable customer mix, while cost for micro-mobility burdened.

Please turn to page 11. Our LV business declined 12.3% on a reported base and Diesel was again weaker than gasoline. Diesel registrations in Germany declined to now only 25.6% in September and 27.3% for the full Q3, both figures marked a new low in Germany. With exception of the Aftermarket division, all other non-LV businesses still faced a very negative business environment. However, our trucks business were able to improve sequentially from minus 42% in Q2 to minus 26% in Q3.

Please continue on page 12. Although China is still down 9.5% year to date, Q3 was the second consecutive growth quarter. Market growth was at 10% in Q3. Our China activities reported a FX-adjusted growth of only 2.4%, but one has to bear in mind that last year showed a remarkable outperformance of around 20% due to the successful introduction of our electrical vacuum and vapor pumps in the Chinese market. We observe, however, a slower recovery pace of our Chinese customers versus the western OEMs, with the latter representing the larger portion of our sales. EBIT grew by 20% to EUR24m. The operating margin of our joint ventures rose by 120 bp to 8.7%. We are expecting that this will again normalize in Q4 due to a less favorable product mix.

Before we start with Defence, I would like to draw your attention to a very successful innovation in our Automotive business on the next page: Those of you, who participated in the last year's capital markets day might remember that we presented a number of innovative products for different powertrains. One innovation was the electronic vapor pump that was born from the need to find a technical solution for a problem that arose from increased regulation for fuel fumes. Rheinmetall Automotive was the first to market to offer this product and since its presentation, orders with a life time value of more than EUR1b for this environmentally sustainable product were booked with different OEMs for sale in the US and the most important Asian markets. This is a remarkable success story and the biggest project in Automotive's history, ever.

With these remarks, I close the Automotive chapter and now move to Defence on page 14.

All production sites returned to normal operations in Q3, obviously with increased safety measures, which had however no material effect on productivity or profitability. Order intake was on the expected lower level. The Hungarian Lynx order will be booked in the fourth quarter, because the necessary export approval has not yet arrived. Q3 sales were not as weak as originally expected during our Q2 call. Excluding a minor adverse FX effect, the operational development was only minus 1.2%. The operating result grew by 18% to EUR76m with contribution from all three divisions.

We reported positive EUR5m in special items in the third quarter. EUR10m resulted from a contractual earn out related to the divestment of the Rheinmetall Airborne Solutions business back in 2012 and were partially offset by restructuring cost for the consolidation of two sites in Germany. The operating free cash flow improved EUR97m to minus EUR7m driven by higher earnings and a significantly improved working capital.

Let's move now on to page 15 for the presentation of the divisional details. Weapon and Ammunition Q3 sales increased by 14% to EUR224m. At the same time the operating result rose to EUR15m. A more favorable sales development with high margin business were the drivers. Electronic Solutions reported an exceptionally high margin in Q3 with 11.5%. Sales declined by 4% to EUR206m, but at the same time the operating result increased by 18% to EUR24m. Main drivers were good execution and some high margin contracts. Vehicle Systems slightly increased operating result by EUR2m to EUR37m, despite a sales decline of 9%. Sales dropped primarily on the expiration of the Puma contract, while the operating margin benefitted from an overall improvement of price quality.

On page 16, you find the order intake and back log details. Q3 order intake compared to a strong previous year that included German orders for VJTF and Hungarian orders for Leopards and howitzers. Although we signed the JV and the order contract for the delivery of the Lynx to Hungary in September, this order is not included in the Q3 order intake. Our expectation for the German share of the order intake for 2020 has now slightly increased from around EUR1.4b which I mentioned in the Q2 call to now around EUR1.6b because of the supportive effect of the German Corona stimulus package, which included a further potential for Rheinmetall trucks. Including the booking of the Lynx contract, total order intake for 2020 is expected now between EUR5.5b to EUR6b. Order backlog remains on the high level of above EUR10b at the end of September and is well on track to achieve a new record level at the end of 2020. Please move now on to page 17.

The Lynx contracts with Hungary definitely mark a milestone in the Rheinmetall history. With this contract we have a launching customer for our 100% self-developed infantry fighting vehicle, the currently most advanced of its kind. The contract provides for a delivery of 227 vehicles in total, split into two phases. We start with the export of 46 vehicles from Germany between 2022 and 2023 and then continue in 2024 with the delivery from the production site of our fully consolidated joint venture in Hungary. The production is expected to last until 2029.

The signed contract only covers the delivery for the vehicles, therefore we expect additional contracts for ammunition, maintenance and spare parts to be negotiated and signed within the next 24 months. This contract win is expected to have a very supportive impact on all other infantry fighting vehicle tenders in Eastern Europe and Australia which have a potential order intake value of up to EUR8b within the next four years.

This takes me now to the end of the presentation on page no. 19. On the back of a more stable Automotive environment, we have decided to provide a full year guidance for both segments: Automotive is now expected to report an operational sales development in the range of minus 20 to minus 23% for the full year. The operating result will clearly return to positive territory and is expected to be in the positive range of EUR10m to EUR20m. Defence growth is expected to be at around 6%, and we are now raising the operating margin guidance from around 10% to a range between 10% to 11% for the full year 2020. Obviously, guidance does not anticipate any significant adverse impact from a second Covid 19 wave for the remainder of this year.

With these remarks, I close my presentation and now we are ready for your Q&A. [0:20:32]

[0:20:41] Operator

Thank you. Ladies and gentlemen, if you would like to ask a question, please press nine and star on your telephone keypad. If you wish to cancel your question, please press nine followed by the star key again. Please press nine and star now to state your question. And the first question comes from Sebastian Growe, Commerzbank. Please go ahead.

[0:21:06] SEBASTIAN GROWE

Hi, good morning, Mr. Merch. Thanks for taking my question. The first one would be around the automotive strategic options process. Can you give us a bit of an update, what is the latest simply around this process where we've seen obviously a pretty sharp recovery I think in the business overall. So I would assume that the appetite might have increased and hopefully also then the overall negotiation is moving more into your favor after what has been eventually very depressed level when you started the exploration process.

The second one would be then around defence. I think I asked it in the past, nonetheless I try again around KMW. I think you can firmly stand on your own feet with everything you are presenting here in terms of orders both booked and also the pipeline. And the EUR8b obviously on the Lynx etc. side is obviously very encouraging. But nonetheless I think this overall option, if I may put it this way, is expiring by year end according to my information. What's the latest here, that would be interested, interesting sorry.

And then the last one is around Germany. You upgraded the target from EUR1.4b to EUR1.6b of orders for the full year. Where are we standing currently? Because it seems that the overall process has been pretty slow in terms of order taking in Germany. So I would be just curious to hear what the current by month figure is from Germany for orders. Thank you.

[0:22:32] Helmut Merch

Okay. Thank you, Mr. Growe, for the question. So I start with your first one, automotive. What about our divestment process? So actually we have started internally the process. We have selected so far the necessary advisors. Internally we are now in full preparation and we are going to market in the first quarter of next year. And we hope that the process will come to an end, to a successful end during H2 2021. And this process is covering the small and large bore piston business.

Coming to the more political question regarding KMW, here I have to state and say clearly no news at all. And so we also have in mind that at the end of this year something should or could happen between the involved parties but this is only a story between the two partners, so actually no news.

Regarding Germany, we have an order intake so far in the first three quarters of around EUR950m, so there is some way to go but we are actually confident that during the last two months we will be able to finalize the remaining orders.

[0:24:34] Sebastian Growe

Thanks, that is helpful. If I may just quickly follow up on the comments you made around both, Auto and also Defence when it comes to strategic side of things. For the auto processe any chance that you simply pull back in case the business was to improve sharply? Or is this really sort of set in stone provided that the overall negotiation is proving successful also from price element etc. that this is really an asset that you will exit?

And around KMW and also the corona impact, is there any sort of element or the option that it might get extended, i.e. that you don’t have to by all means find an agreement by year end because of the special environment that we are in?

[0:25:19] Helmut Merch

I think it is always depending on the process. We are definitely not desperate, but we have decided very clearly that we want to step out of the piston business. So we are not going back.

[0:25:36] Sebastian Growe

Okay, that's a clear statement. And on the timing of the option?

[0:25:41] Helmut Merch

Yes, this will depend on the development of the process we will start during Q1. We have a lot of work to prepare as - you could imagine - because it is now an integral part of the whole business and we have to prepare the necessary carve out and so on, and this needs a bit of time. And after having done all these preparations we are planning to go to market during Q1 and assuming a normal process within six to nine months, one could come to an end.

[0:26:32] Sebastian Growe

Yes, that's appreciated. My question was more related to the KMW situation, so if there are sort of this kind of hard deadline being year end 2020 ?

[0:26:43] Helmut Merch

Okay, sorry. Then I missed some words. No, we now have to sit and wait. Every contract has some potential to be re-negotiated but we are not one of the partners. This has to be done between the family tribes and the French state. If there is a need to renegotiate a given contract, probably they will do but I have no real information what could be the outcome. I think we have to wait and see. If there will be an official announcement end of this year, or beginning of this year or there will be no announcement, this could also be a statement. So actually we have no better insight as of today.

[0:27:47] Sebastian Growe

Okay, very clear. If I may, the very last one, I promise, around Defence and the guidance around 6%. What has triggered really this sort of slight modification to the downsize [by] 6 to 7? Everyone looks at Quarter 3, I think the expectation was rather minus five, now we are coming in at minus two mostly currency related. Is there anything really in terms of timing of the backlog in particular that we have to be aware of?

[0:28:13] Helmut Merch

Yes. That is not a timing of the backlog execution. Actually, as you know, we have still some order intake to book during one business year and also executing or delivering in the same year. And here we actually see some delays and slippages of short-term orders in the Weapon and Ammunition division and this leads us to this revision and we see a potential of slippages into Q1. But this is not a major issue. We expect the order intake but sometimes customers are not willing to be pressed and then they will give us these short-term orders during Q1. So this is the rationale behind it.

[0:29:14] Sebastian Growe

Even better than that you have nonetheless raised the EBIT margin guidance. Thanks for the color.

[0:29:20] Helmut Merch

Welcome. Thank you, Mr Growe.

[0:29:26] Operator

Please be reminded to ask your questions one by one. We will provide ample time for all your questions. And the next question comes from David Barker, Bank of America. Please go ahead.

[0:29:40] David Barker

Good morning. Thanks very much for taking my questions. I've got three. So firstly on free cash flow. I think Q3 was clearly better than expected. How should we be thinking about cash for the full year? Because I know you've talked about neutral in the past. That's my first question and then secondly, should I ask all my questions first?

[0:30:00] Helmut Merch

Yes, so I pick up your first question. So on the back of a good cash flow generation in Q3, we are a little bit more optimistic regarding the full year. So a cash neutral situation at the end of this year would be the worst case scenario. We are actually driving for a better situation so actually our target is to be cash flow positive. I do not want to guide a specific number, but the cash neutral position would be the very worst one and therefore we are very positive to produce a positive free cash flow at the end of this year.

[0:30:54] David Barker

Okay, fantastic, that's very helpful. And then a second one was just a follow-up on the guidance and please forgive me if I'm mistaken here, but if you take the midpoint of the Group guidance on profit and the midpoint of the divisional guidance, there seems to be some delta on the profit implied. That would assume then that the consolidation costs, I think, need to be a bit higher in Q4. Can you just shed any color on the two differences? Am I right in saying that Group corporate costs or consolidation costs will be higher?

[0:31:29] Helmut Merch

Yes. In Q4 this will be the case. It will be a little bit higher from the existing standpoint. But on the other hand, if we raise our guidance for Defence, I personally would say that the guidance for the operating margin in Defence will not end up in the midpoint but more at the upper band of our range.

[0:32:07] David Barker

Okay, fantastic. And then just one final one for me on automotive. I think you just said, and I'm sorry about background noise, you said in October that auto sales were up 5%, so I think you're implying quite a significant slowdown in November and December. Can you give any light on what's driving your underlying assumptions for the rest of the year?

[0:32:31] Helmut Merch

Yes. So there is still – what I try to give you a flavor. There is still a high uncertainty, especially around December. If, and we experienced similar situations the last couple of years, that the OEMs, in order to reduce working capital or in order to preserve cash out, they have stopped immediately the call-off before Christmas. Therefore we are still more or less cautious/optimistic for the running months. But we have actually no sight or no view about the performance in December. Therefore we are a little bit more on the cautious side.

In case we will see a situation like October, which was, to our knowledge, also a little bit surprising, if this will continue, we could also have some chance to be at the lower band of our top line guidance. But there is still a great uncertainty regarding December. So that is our latest view.

[0:34:02] David Barker

Okay, great. Fantastic. Thanks for the answers and have a good weekend. Thanks.

[0:34:07] Helmut Merch

Yes. Thank you, you too. Bye.

[0:34:11] Operator

The next question comes from Sash Tusa, Agency Partners. Please go ahead.

[0:34:17] Sash Tusa

Thank you. Good morning. It's Sash Tusa. I've just got a very simple, I hope detailed question about the export licensing for the Hungarian contract. I think you said that this hasn't been signed yet. And I wondered, is there a known schedule for this, a date at which the government is due to assess this export? Or is this something that could be delayed through the court?

And when the export license is signed, does the contract come into effect immediately, or is there then a delay while you physically sign and receive any prepayment?

[0:35:00] Helmut Merch

Yes, that is a good question, Sash. So my answer is when we receive the signed export approval, the contract immediately will be in force. Why? We recently got the down payment from the Hungarian government. So then everything is safe and sound. Normally this process will last six to eight weeks. And we have no signal that this would pass into next year because we see no reason: a) Hungary is a member of the EU. b) Hungary is a member of NATO. So actually, we have no single sign that somebody is delaying the process. So therefore, we expect during November or at the very latest in December the final approval. Anything else would be to our position a very surprise.

[0:36:19] Sash Tusa

Lovely. Thank you very much.

[0:36:22] Helmut Merch

Thank you.

[0:36:26] Operator

The next question comes from Chloé Lemarié from Exane BNP Paribas. Please state your question.

[0:36:32] Chloé Lemarié

Yes. Good morning, everyone. I'll have two actually. The first one is on automotive margin in Q3 was particularly strong, given the circumstances. I was wondering if you had anything particular within that mix that would be non-sustainable going forward. Because typically Q3 aren't very different from the full year. So when we think of 2021, could it be a good starting point?

The second one is on the proceeds from the sales of pistons. Strategically where would you wish to use the proceeds? Would it be used to fund acquisition? And if so, which area would be key to reinforce according to you?

[0:37:17] Helmut Merch

Yes. So first question, within Q3 results there were no exceptional items included. This was on the back of higher volumes and I have to confirm it once more on a very strict costs and CapEx management. So therefore we expect also a good leverage in Q4 this year.

And regarding the potential proceeds, a) we have also spoken in Q2 call that we are going for a further transformation in our mechatronics business. Here we would invest some money. And in case if further transformation requires an additional **M&A** transaction, that also could be a potential use of proceeds. But firstly we have to close a deal, then we will look how we invest the corresponding proceeds.

[0:38:29] Chloé Lemarié

All right. Just on the auto margin. Nothing particularly that would actually drag the performance into 2021, so 5% is not an unsustainable level?

[0:38:45] Helmut Merch

I think we are ready to perform with higher volumes. And I think it is too early to provide a guidance for 2021. But I think we will clearly look how Q4 will perform, and what is the perception for the potential growth of the overall market environment in 2021.

[0:39:17] Chloé Lemarié

All right. I tried, but thank you for the feel.

[0:39:24] Helmut Merch

Welcome.

[0:39:26] Operator

The next question comes from Christian Cohrs, Warburg Research. Please go ahead.

[0:39:30] Christian Cohrs

Yes, hello. Good morning and thanks for taking my questions.

[0:39:33] Helmut Merch

Good morning.

[0:39:34] Christian Cohrs

I've a couple of them; l will ask them one by one. The first with regards to Defence. Would you still say it is a super-cycle you're actually in? There are increasing rumors or speculation that also due to the pandemic, public finances are ruined and that states must reallocate money from defense to public healthcare etc. Maybe you could shed some light on that one.

[0:40:06] Helmut Merch

Yes. Regarding our increasing order backlog, regarding our expected acquisitions pipeline, I for the time being would confirm that we are still in a super-cycle. We have to bear in mind that there are some countries with lower budgets and which are highly under big pressure from the pandemic. They have already announced that they want to reduce their defense spending but either they have only little money to spend or these countries are not accessible from our side. So these countries are out of scope, countries like Australia, countries like Germany or a special political need in the Eastern part of Europe, because they have to align with NATO standard. All these movements are still in the right direction. I will not exclude that there will be some delays. But I think we have a great potential to build up our order backlog in the next two or three years in the range of EUR15b to EUR18b. And then we have to deliver on this backlog. So from our perspective, Rheinmetall's perspective, I would confirm that we are still in a super-cycle.

[0:41:49] Christian Cohrs

Okay. That's very clear, thank you. And then maybe short-term, the order backlog for 2021 actually stands at EUR2.3b at present. This is pretty much the same figure which you have presented for 2020, one year ago, with the release of that month's result 2019.

[0:42:11] Helmut Merch

Yes, exactly. Yes.

[0:42:12] Christian Cohrs

Does this actually then signal a flattish top line performance in 2021, or, do you think there is more to come? Do you expect there will be a good year of growth?

[0:42:26] Helmut Merch

Yes, I think every year in which we deliver some growth is a good year and now one has to look, what is the magnitude of growth. We have a lot of order intake to come also during Q4, which will be for delivery in next year. But I think it is a little bit too early to provide you a guidance for growth in 2021. I can state so far that we will grow, but the level of growth will be given to the market during our March conference call.

[0:43:18] Christian Cohrs

Okay. And then from top line, maybe to margin you just said, and you just actually said you would rather expect the upper half of the 10% to 11% range. Is this simply the margin improvement? Is this simply due to execution and better price quality and do you expect this to – and do you think that this margin can be sustained or is this a very exceptional product mix this year, which is unlikely to reoccur next year?

[0:43:51] Helmut Merch

Yes. It's also a good question, Mr. Cohrs. I think it is a mixture of all you have already mentioned. We have A, a good execution, B, we have the phasing out of the famous legacy contracts. So we will see the last, I guess, EUR10m or EUR15m of Puma in Q1 2021. So already this year we have only a very small impact from the Puma contract. And having been said several times, the replacement of the phasing out of Boxer and Puma is being done by good contracts. So this is a – should be a sustainable situation.

I would say that we should move also within the next couple of years between 10% to 11% is reachable. That is our aspiration, our target. Dropping below 10% could be a situation in case we have to face some major headwinds from customers or so. But I think once having reached 10%, this should be a line being defended in the next couple of years. And the ability to be over 10%, in the region of 11% or so, this is very much depending on the mix of different orders, as you know.

We have different products, we have different customers, we have different countries and if everything is perfect, then I would assume the region of 11%. If we have some headwinds out of some situations I think we should be able to defend 10%.

[0:46:15] Christian Cohrs

Okay, thank you. And then maybe just on Automotive, you have done some impairment on – at equity participations. Did these occur actually in Q2 or in Q3? And you, I think – are the equity results included in the EBIT and operational result? So this is impairment then also then stripped out in the operative earnings?

[0:46:43] Helmut Merch

Yes, although the impairment which we have done so far was fully executed in Q2 and was stripped out of the operational results.

[0:46:57] Christian Cohrs

Okay. Also the equity impairment? Okay.

[0:46:59] Helmut Merch

Also. Yes, including.

[0:47:02] Christian Cohrs

Yes, okay. That's fine, thank you. And last question, maybe there are increasing discussions about ESG and with regards to – or put it this way, your Automotive divisions, actually in some, you may call it "clan liability", was defence business from an ESG perspective. So is ESG potentially a game changer that you might reconsider? Not just the disposal of large-bore pistons business, but that might be also a game changer with regard to the Group structure of Rheinmetall so that you actually separate the business and do actually a bigger move with regards to Automotive.

[0:47:51] Helmut Merch

That is a fair question especially in the light of the divestment of the Henderson Fund the other week. This was driven by ESG reasons, so we were told. There is, as you know, there is an ESG wave in the market. We have a business model which clearly centers around defense. And here we will not discuss our strategic direction. And also given the fact that we have decided to step out of the piston business, will not be withdrawn in the light of the ESG discussions. I think this is a strategic direction where we have decided to concentrate more on products around electronics, Mechatronics and we are looking for a better owner than we are in the piston business. So we have to look what will be in the next couple of quarters or months, but we cannot fight the ESG wave. We are only able to give light on our strategic direction. We can deliver our performance and then the market has to evaluate. But we are not willing to give up our Defence business in the light of the actual ESG discussion.

[0:49:49] Christian Cohrs

That was not the intention of my question. I actually thought – I mean, Automotive, ESG is not just linked to equity. It's increasingly also linked to the debt market and Rheinmetall Automotive being part or being actually a brother or a sister company of a defense company might also – that could actually mean or could potentially mean that ESG becomes even more dominant, that it faces adverse effects with regards to having access to capital, either equity or debt. And this actually might then trigger to separate the Company into two parts.

[0:50:29] Helmut Merch

Okay, now I've got you. Sorry. Now I've got you better. No, I think we have now decided one strategic step and first we want to finalize this strategic step and move. And then at the end of next year, we have a new situation. We have a new, hopefully a new setup and then we have to think about the ongoing future. But for the time being, I would exclude that there will be a second move in short-term.

[0:51:12] Christian Cohrs

Okay. Thank you, very clear. Thank you very much.

[0:51:15] Helmut Merch

Welcome, Mr. Cohrs.

[0:51:20] Operator

The next question comes from Joseph Ayoola from Morgan Stanley. Over to you, Mr. Ayoola.

[0:51:27] Joseph Ayoola

Hello Mr. Merch. Thank you for taking my questions.

[0:51:29] Helmut Merch

Hello.

[0:51:29] Joseph Ayoola

Hi. I've got just two questions today. The first one was just coming back to defence margins and capitalized R&D. You've highlighted that capitalized R&D is going up a bit this year. Can you maybe quantify how much you expect for the full year and whether this is going to be peak and/or reduce in future years? And my second question is just on mid-term guidance. With the last of the CMD this year, would you expect to provide three-year rolling guidance as you normally do with Q4 results? Thank you.

[0:52:08] Helmut Merch

Referring to your last question, I have to disappoint you. We will update our mid-term guidance I think not this year, but I guess we have the chance to provide you with some information during our conference call in March. To the first question regarding activated R&D, so in the first nine months, we have capitalized R&D on Group level of EUR47m. And for the full year, we expect a value of roughly EUR65m or EUR66m. This will be EUR25m higher this year due to the programs I already mentioned, Land 400, and also, and we are actually also activating some developing efforts for the Phase three. And additionally for the future tactical trucks we expect also next year a similar volume, but then from 2022 onwards, we will see then a declining volume. So the year, also with the CapEx, which is combining with the new site in Australia, we see a temporary peak, and then we expect a normalized level from 2022 onwards.

[0:54:07] Joseph Ayoola

Helpful. Thank you.

[0:54:08] Helmut Merch

Welcome.

[0:54:11] Operator

The next question comes from Christoph Laskawi, Deutsche Bank. Please go ahead.

[0:54:18] Christoph Laskawi

Hi, good morning. Thank you for taking my question.

[0:54:20] Helmut Merch

Morning.

[0:54:21] Christoph Laskawi

The first one will be on Automotive. And given that you have apparently now selected the advisors, should we expect some carve out cost to be booked in Q4 when you are preparing to sell the business? Or is that more something we should expect in Q1 or Q2 next year, if at all? That's the first question.

[0:54:43] Helmut Merch

Yes, so in Q4, we expect only little for some advisory fees, but this is very low. If at all, we expect some costs in Q1 or Q2. But this should be on a single-digit million level.

[0:55:08] Christoph Laskawi

Thank you. And as a second question, a bit more long-term, and also on the Defence margins, you essentially just said, mid-term, you see margins between 10% to 11%. Given that you see quite substantial growth coming up in the vehicle systems business, would you say also the Lynx project is generally supporting that range, or could it even improve that going forward?

[0:55:36] Helmut Merch

So we, Mr. Laskawi, we will not stop at 11%. But I think, as you know, we are in an also challenging business. We are delivering or running projects over six to seven years. I tried to give you some flavor regarding the Hungarian contract. So we are signing this year in 2020, and the last delivery out of the joint venture will be done in 2029.So we are covering periods of seven, eight, nine years.

And therefore I think it is good to provide a mid-term guidance and then explicitly look to the next budget year. And if so, and I'm not pessimistic on this challenge, but if everything goes right, then we have also the situation that we can surpass 11%. But it is not wise to guide actually on this aspiration. But you are right, in case we can benefit from operating leverage, we can benefit from good contracts, we are ready to deliver the best margin we could get out of the business.

[0:57:03] Christoph Laskawi

Thank you. That's understood. Last question will be on the stimulus package in Germany, not specifically on Defence, but in general, it was quoted that a lot of the money that was allocated wasn't really spent yet or reallocated to specific projects. Is it the same for Defence and could we expect more of that stimulus to come to early 2021? What is the difference?

[0:57:32] Helmut Merch

Yes, it's good. We expect actually orders to come before end of this year. This was the rationale behind my increase of the German order intake, but also there are potentials for next year. But here we will see what really happens. You are fully right. A lot of money being promised is not yet allocated and even not spent. And therefore, we're still fighting for every EUR1m out of this stimulus package. And hopefully we get the first couple of a hundred millions this year, but there is still some budgetary money left for next year.

[0:58:28] Christoph Laskawi

Thanks. And is there certain buckets you know of that the government would like to allocate it to, say in ammunition more likely than in other vehicles?

[0:58:37] Helmut Merch

No, the biggest bucket, if you call it so, is additional vehicles. The army needs, trucks and trucks and trucks.

[0:58:54] Christoph Laskawi

Excellent. Understood. Thanks a lot.

[0:59:45] Operator

We have one more question from Mr. Weier, UBS AG. Please go ahead.

[0:59:55] Helmut Merch

Okay.

[0:59:56] Sven Weier

Yes. Hello, Herr Merch, finally.

[0:59:58] Helmut Merch

Herr Weier.

[1:00:01] Sven Weier

So the first one is a slightly longer question, apologies for that, but it ties in also somewhat to what Christian asked earlier, the share price, right? I mean, I guess we have several buckets of pressure here. ESG, I mean, we know there's not much you can do about that. Secondly, I guess the uncertainty about the defense budgets, where I think you could do something about it, like you always do at the CMDs, i.e. outline the pipeline precisely, and maybe tackle those orders more specifically where the risk is. And then thirdly, I guess also the question of some people, you know, if you get out of pistons, what does that actually ultimately mean for the Automotive, because the division, is it big enough to be standalone? So my question is normally you have CMD in November, it doesn't take place this year, of course, but should we expect you to do something instead in the coming months?

[1:00:57] Helmut Merch

Yes, so we – definitely we'll do something in the coming months. We have not decided when, but I think on the back of the announced divestment of the piston business and more focus on Mechatronics, I think this could be the trigger for a more comprehensive strategic outlook, which we will give I think in the beginning of next year. Regarding the other things, ESG, the potential rest of Auto, we actually have decided our first step. And we do not see the need for the second step because the second step should be thought when you have closed or signed the first one. So I think we have to carefully watch the situation in total, but we do not want to overstress the situation. We are concentrating on our deliveries and therefore we will and want to execute what we have announced, Mr. Weier.

[1:02:40] Sven Weier

Okay. So looking forward to January then overall. The second question is also kind of a follow-up, when we think about next year sales, we talked about the EUR2.3b and you can't quantify the growth yet. But on the other hand, you have mentioned track framework as a shadow backlog process, that I guess comes on top of the EUR2.3b that you have now already. I mean, what size should we have in mind of this shadow book for next year then? Is there kind of a range that could come through or –?

[1:03:15] Helmut Merch

That is not yet decided. We try to give you a flavor that the execution timeframe for the framework for the shadow backlog is between 2021 and 2026. And we are in close contact, especially with the German customer on how many trucks he will need and how many trucks we can produce. And we are fully concentrated on the German customer, but luckily we have also some other customers with whom we have fix and firm contracts. So this is a variable we have to report on through the respective budget year, Mr. Weier. Therefore I'm not able to give you an explicit and precise figure of what, out of the shadow backlog, we are able, and we are ready to deliver in 2021 or 2022.

[1:040:27] Sven Weier

But basically, I mean, you mentioned the order intake that you now have in Q4 for next year, which seems a little bit higher than you might have had last year for this year. Plus these ones of the growth rate might actually be not that low, to be honest.

[1:04:45] Helmut Merch

That is your assumption. I do not want to confirm the assumption. I only have said that we want to perform a further year of growth. The range of growth we are going to provide in March conference.

[1:05:04] Sven Weier

And then I had a follow-up question on your guidance for this year, because that also ties into the previous question. If I take, for example, the high end of your Auto, your Defence guidance, I can compare that with the Group high end. I come up with holding costs, consolidation line of EUR15m, which is probably – definitely not what you would expect, but I guess it's probably more around EUR20m to EUR25m. So is it the case that the high end of your Group guidance is not the combination of the high end of the auto and the high end of the defense guidance?

[1:05:37] Helmut Merch

Mr. Weier, it is the attempt to give you some flavor, what is our target at the end of this year? If we have any chance to over-deliver, then we are happy to do so. But still we have an uncertainty in the economic environment and everything could happen on the last 10 meters in this year. And it is not wise to outstretch the goal and then to fall low. We do our best to give the best results we can provide this year.

[1:06:28] Sven Weier

Yeah, we appreciate that. Thank you. And the last question is just when we think about temporary savings you had in Automotive this year, like Kurzarbeit and less travel cost, marketing and all these buckets. When we then go a little bit, think forward to next year, I mean, hopefully we don't need Kurzarbeit anymore next year and have more travelling again and marketing. Should we just simply assume that you replaced the short-term temporary savings by the structural program you do instead?

[1:07:06] Helmut Merch

Yes, if I add up the savings out of the short-term work, I end up with roughly EUR40m. I think this cannot fully offset it by structural savings. I give you some flavor regarding structural savings of EUR20m, which should be the starting point in 2020, and should support our EBIT development next year. And we will have some sustainable cost measures in place. We are going to reduce our travel costs. We are going to reduce our marketing costs. We are not convinced that next year a lot of fairs will take place. So we will safeguard some temporary effects out of 2020, also in 2021. And then, by the way, we expect a good positive leverage in case of increasing volumes.

[1:08:22] Sven Weier

Sounds good. Thank you very much, Mr. Merch, and have a nice weekend.

[1:08:26] Helmut Merch

Yes, thank you, Mr. Weier, and also a nice weekend for you.

[1:08:32] Sven Weier

Thanks.

[1:08:35] Operator

If you have any additional questions, please press nine followed by the star key again.

[1:08:50] Helmut Merch

So if not, then I thank you all for participating in our Q3 call and your interest and questions. Stay safe and healthy and have a good weekend. Bye-bye.