Rheinmetall AG
Investor Relations
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Transcript

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Content

	Contribution	Course	Duration (min)
	Presentation - **Begin**		
	Presentation - **End**		[0:18:57]
	Questions:		
1	***Sven Weier, UBS AG***	19:19	7:17
2	***David Barker, Bank of America***	26:42	2:54
3	***Joseph Ayoola, Morgan Stanley***	29:47	7:13
4	***Sebastian Growe, Commerzbank***	37:11	5:23
5	***Alexander Hauenstein, DZ Bank***	42:44	7:42
6	***Sash Tusa, Agency Partners***	49:40	1:39
7	**Christoph Laskawi, Deutsche Bank**	51:30	4:33
8	**Chloé Lemarié, Exane**	59:25	2:02
9	**Christian Cohrs, Warburg Research**	59:25	3:57
10	**Christopher Hallam, Goldman Sachs**	1:3:49	1:02

Rheinmetall AG Conference Call

00:00:01 Operator

Good afternoon, ladies and gentlemen and welcome to the Rheinmetall AG conference call regarding the first quarter results 2021. 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.

[0:00:21] Helmut Merch

Thank you for your kind introduction,
Ladies and gentlemen, Welcome to the Q1 2021 earnings call. I will walk you through our presentation, which we have adjusted to reflect the new corporate reporting structure and will then be available for your questions. Before we continue with a Q1 highlight, let me draw your attention to our legal disclaimer on the following page. And then we will start with the group highlights on page no. 3.

Our business environment in the first quarter was marked by a strong recovery in our main markets, led by the Asian economies, which obviously were hit most by the pandemic at the beginning of last year. At the same time, the supply chain situation started to raise some concern because of the semiconductor shortage and price increases of some raw materials. While the market recovery is visible in our top line growth, Q1 remained fortunately unaffected by those supply issues.

Rheinmetall delivered a sound start to the year from a financial perspective, which I will present in more detail on the following pages and our restructuring made progress as planned. All businesses showed continued cost and capex discipline to help to deliver this financial performance.

Let‘s turn now to page no. 4 with some comments on the Q1 highlights.
Rheinmetall is preparing to participate in the Bradley replacement process in the US, which is expected to start in the coming months. In order to present a

convincing offer, we have now L3 Harris to join the Team Lynx, which already consists of Textron, Raytheon and of course our American company. L3 Harris contributes their experience in the areas of communications and cyber security.

Another great success in Sensors and Actuators is our fuel tank isolation valve. Latest regulation in Asia requires now the complete isolation of the fuel tank in hybrid operation mode. We presented the product at our 2019 capital markets day and booked now the first contracts with an international OEMS from Asia and Europe in Q1 2021.

Our casting business continues to be very active in alternative powertrains and we booked additional e-engine housing orders with an international automaker that will be used in their entire e-fleet, confirming our market position and reputation as a leading casting solutions provider.

Please turn to page no. 5. Order intake for all divisions rose by 3.5% to EUR1.2b. The order backlog remained on the high level of close to EUR13b with an additional shadow backlog from already signed framework agreements of around EUR3.5b.

The new KPI “booked business” applies only to the divisions Sensors and Actuators, Materials and Trade and for now Pistons.

This KPI is calculated on the basis of the value of signed nomination letters over their contractual life time. The customer’s actual call off volume however, might vary from the original nomination letter volume, but this is industry standard practice.

The Q1 booked business rose by 42% to EUR890m of which 25% were already for products for alternative powertrains. For example, an electric oil pump for an electric car with a total contract value in the triple digit millions. Please join me on page no. 6 for the key financial data.

Sales increased FX adjusted by 5.1% to EUR1.4b. Although Q1 2020 started to see first signs of the pandemic, the impact was still limited to the former automotive businesses and here the Asian sales, where the pandemic hit first, thus only a limited impact for Rheinmetall.

The strong recovery of the operating result from EUR34m to EUR87m clearly benefited from this favorable sales development, but even more so from the continued cost discipline in all our businesses.

This strong operational performance led to an increase of 280% of earnings per share from EUR0.30 to EUR1.14. Please continue on page no. 7.

Operating free cash-flow had also a very good start to the year. We can report an improvement of EUR129m to EUR-59m. Main drivers were the strong earnings increase of EUR40m and the improvement in our net working capital position of roughly EUR70m. The latter driven by prepayments while receivables and inventory increased due to higher business activity. We continued with our opportunistic CTA funding in Q1 2021, but the contribution was EUR70m lower compared to last year.

Please turn to page no. 8. Our balance sheet is still rock solid and with the equity ratio of roughly 30% we are now almost back on our target range of 30% to 35%. So basically, we have almost fully compensated the impairment effect from last year on equity. We have no major debt payback scheduled for 2021 and our liquidity provides for enough flexibility to pursue our M&A strategy without a financial stretch.

Please move now to page no. 9 starting with the explanation of the divisional segments. Order intake in Vehicle Systems rose by 30% to EUR178m. Sales declined according to our plan by 8% to EUR409m as some tactical vehicles ramped down as expected with according impact on the operating result, which softened, from EUR35m to EUR25m. The operating free cash flow rose by

EUR100m to EUR79m upon receipt of first down payments from our Hungarian order from Q4 2020.

Please turn to page no. 10. Order intake for the division Weapon and Ammunition remained 30% behind and ended at EUR228m in the first quarter. Q1 2020 included a large international propellant order of high double-digit million value. Sales increased by 32% to EUR220m due to higher volumes mostly related to an order that was brought forward at customer request from Q2 2021. The size of this order is around EUR60m. Operating result gained EUR33m to EUR18m on the above mentioned effects of higher volumes and favorable mix. This favorable financial performance continued in the operating free cash flow, which advanced 22% to minus EUR-56m.

Now moving on to page no. 11. Electronic Solutions reported an order intake of EUR218m, which compares to EUR324m in Q1 2020, Q1 2020 but included a large international air defense project. Sales were slightly softer by minus 4% and ended at EUR167m but the operating result remained stable at EUR10m, generating a slight margin increase. Operating free cash flow included for the first time a CTA funding of EUR15m and additionally declined due to working capital build-up to prepare for imminent businesses.

Now please turn to page 12. The Division Sensors and Actuators reported a material increase of their booked business, achieving EUR656m, which was related to the overall market recovery. The increase included a high share of alternative powertrain products of 33% after 30% in Q1 2020, underpinning the importance of alternative powertrains and at the same time the quality of our present product portfolio.

The sales increase of 7.1% to EUR372m was held back by adverse FX effects. Strong demand for our commercial diesel products from China and India and net positive ramp-ups were the key drivers. Positive volume effects and the continued strict cost discipline contributed to the result improvement of EUR18m to

EUR28m. Operating free cash flow declined by EUR6m to EUR-38m due to business related working capital increase.

Please continue on page no. 13. Booked business of the division Materials and Trade rose by 27% to EUR173m, benefiting from a high share of new customer projects. Sales gained 14% to EUR160m based on a broad regional demand recovery, resulting in the doubling of last year's operational result from EUR7m to EUR14m. The swing came with EUR4.5m from the at equity result of our casting joint venture. Operating free cash flow declined by EUR8m to EUR-9m. This was mostly driven by a working capital build-up because of higher business activities and additional safety stock for critical products.

Moving now on to page no. 14. Pistons tripled their booked business from EUR21m to EUR60m. Sales declined by EUR9m to EUR140m on a reported base. Adjusted for an unfavorable FX effect of EUR11m, Pistons would have generated a slightly positive sales development. Operating result rose from EUR-6m to positive EUR3m. This was a positive effect due to continued cost discipline and lower depreciation as a consequence of last year's impairment. At equity results had a positive contribution. Operating free cash flow turned positive from EUR-11m in Q1 2020 to EUR2m in the current quarter, because of improved earnings and lower capex.

Please continue on page no. 15. Looking at the key end markets for the divisions Sensors and Actuators, Materials and Trade and Pistons, the key drivers for growth were the truck market, the spare parts business in Materials and Trade. While trucks grew in all regions, China was particularly strong, because the introduction of the China 6 emission standards is now implemented and creates high demand for our commercial truck business. We are expecting to be able to outperform regional truck growth in China and India due to this special regulatory driven demand. The increasing demand in our spare parts business made the aftermarket business the second driver with a pickup of almost 20% plus. In summary, non-LV markets drove the quarter's improvement.

Please turn to page 16 for the overview of our Chinese activities. Although the general Chinese market recovery was 18 percentage points above our sales growth increase of 60% in the first quarter, we are very content with the improvement, because our decline in Q1 2020 was less pronounced and hence our comparison base higher. Total EBIT gained EUR21m to plus EUR16m, improving margin by 9 percentage points to now 6.2%.

Please move now on to page no. 17 for our actual market view. Rheinmetall continues to operate in a generally favorable business environment in all divisions. Defense budgets in our key markets are all set for growth and the expected budget cuts for 2022 did not enter. Let me give you an update on our current tenders: Germany has already approved on a strategically important order for engineering vehicles in April with a volume of roughly EUR240m and we are expecting to book the Challenger contract imminently, volume around EUR760m; another important decision to be taken by the German budget commission for the VJTF upgrade of the Pumas is now scheduled for end of June. Volume is around EUR450m. For the second half of 2021 we see further potential for a large Hungarian ammunition contract.

Light vehicle production volumes are expected to recover from the pandemic at a double digit growth rate in 2021, however the market is currently down-rating the growth expectation for the second quarter. Semiconductor shortage is posing a threat to the outlook and as already indicated, we might not be fully immune to this development. Semiconductor supply is scarce and call offs return to higher volatility levels. Raw material prices for certain metals and plastics continue to increase. We are protected by pass through clauses and hedging, but pass through comes or will count with a time lag. On top of that, logistics are becoming more of an issue, because transport capacities are running tight.

Moving on to page 18. The current progress of our piston disposal process requires to apply the standard IFRS 5 as of Q2 2021, presenting the piston business as a discontinued operation. This sets a new base of IFRS adjusted 2020 group sales of EUR5.4b and an operating result of EUR452m lifting the adjusted operating margin by 1.1 percentage points to 8.4% as a new reference base. This is the new base for our 2021 guidance and on the following page, we present the IFRS adjusted 2021 group guidance. Please note that no other adjustments have been introduced.

I would like to start with the trading update for the second quarter, before I come to the full year guidance.

Overall, we are expecting a convincing Q2 performance with a strong order intake, led by a large vehicle order from UK and Germany. Sales growth will be driven by further recovery of the Light Vehicle end market and is expected to be significantly above the previous year quarter. Margin is expected to improve to a range of 7% to 8%.

I have presented the mechanics of the IFRS 5 guidance adjustment on the previous page. The updated guidance includes only the adjustment of the piston business as discontinued operations, we continue to guide operational growth range between 7-9% and adjust the operating margin to now 9% to 10%.

This concludes my presentation and I am now available to answer your questions.

Operator

Ladies and gentlemen, if you would like to ask a question, please press nine and star on your telephone keypad. In case you wish to cancel your question, press nine star again. And the first question comes from Sven Weier from UBS. Please go ahead with your question.

[0:19:19] Sven Weier

Yes, thanks for taking my question, hallo Herr Merch.

[0:19:24] Helmut Merch

Hallo Herr Weier.

[0:19:25] Sven Weier

I start with the first one regarding the political environment. Of course everybody starts talking about the German elections and what happens there. I was just wondering not for an election prediction from you, but when you think about your mid-term Defence targets, right? How much do they actually depend on you winning bigger ticket items from Germany after, let's say September this year? I mean, is it not that most of your medium-term targets are backed up by the stuff you have in the backlog already? And when we think about bigger projects, most of them are outside of Germany after September? But correct me if I'm wrong. Thank you.

[0:20:12] Helmut Merch

So I would like to confirm our mid-term guidance for the expected order intake from Germany in the range of EUR1.5b up to EUR2b. This will be the case this year but also it is toexpected for the upcoming years. In case we are facing a black-green coalition, then I would not say that there will be further budget cuts. I think we are now at a level of a defence spending of around EUR50b or so. I think with this level, this will underpin our expectation regarding our mid-term order intake from Germany. There is still a strong need to restock the ammunition depots. There is still a strong need to modernize the existing fleets. There is still need to fulfill the commitments regarding VJTF. So there is a lot to come. I saw late in the evening, a remark from the present Chancellor, Mrs Merkel that she is still highly committed to reach the 2% of defence spending with regard to GDP. We always said that we are not really looking to this 2% figure, but a stabilization on 1.5%-1.6% or even 1.7% level would be a comfortable situation for us.

[0:21:56] Sven Weier

And you think, is that 1.5%-1.6% is that also possible without, you know, obviously there was media reports about the Puma order here, which I think would be a really big one. But would you think that the 1.5%/1.6% that's possible with smaller and mid-sized orders. Not only high-profile ones there.

[0:22:16] Helmut Merch

Yes, that is correctly understood by you. I think the speculation around the second Puma lot is still there. But I think not everything you can read in the press is fact-based, I would say. I already gave some comments on our expectations regarding the upgrade for the first Puma lot in respect to the VJTF commitment. Here we had strong signals that a decision will be taken end of June but clearly to say that a decision for a second Puma lot will not be taken before the election. So this is a discussion which will go into 2022.

[0:23:14] Sven Weier

Understood. The next question I had was just on pistons, whether you could give us an update. How the pipeline of potential buyers has developed further since the last order update. I guess you probably have down selected substantially. Obviously you've changed the guidance for discontinued operations. I was just wondering what kind of EBIT did you have in mind for pistons stand-alone this year? Would there be also kind of a range you could share?

[0:23:47] Helmut Merch

I would not disclose this for various reasons, but what I can say regarding the process: We have now made a down selection to twenty five interested parties. We have sent out a big info memorandum and the first meetings have already taken place. Our timeline is still valid, that we expect during Q3, at the latest, beginning of Q4, some valid decisions upon the sale of pistons.

[0:24:36] Sven Weier

Okay, good to hear. My final question please on the trading update. Thank you for that for Q2. I was just wondering how you look at the quarter more sequentially. Do you think you will be above Q1 in both divisions or is that more on the defence side, whereas on the automotive it is going to be a bit tougher quarter given the environment?

[0:24:59] Helmut Merch

I would say that Q2 will be a little bit tougher for the Auto divisions, because we see some potential impact from the semiconductors shortage. Actually to give you a flavor with respect to original commitments from our suppliers we are now missing roughly four hundred thousand chips. Therefore, we already see some small impact on the April sales, but I think I would assume a sales impact of around EUR24m up to EUR30m due to the shortage of the chips. But I think we also have some signals that there could be a recovery in H2 but therefore we see some small impact on the topline in Q2.

[0:26:13] Sven Weier

But EUR24m to EUR30m is for the entire quarter? Not just April obviously?

[0:26:17] Helmut Merch

No, no. April was around EUR10m so now you can take another EUR10m for May and June, and then you can come up with roughly EUR30m.

[0:26:30] Sven Weier

Understood. Danke, Herr Merch.

[0:26:32] Helmut Merch

Gerne.

[0:26:37] Operator

The next question comes from David Barker from Bank of America. Please go ahead with your question.

[0:26:42] David Barker

Good afternoon. Thank you for taking my question. Just two quick ones. Firstly, on the cash guidance, I think for 2021 you'd said in the past that it would be closer to the 3% for sales, than the 5%. Can you just confirm that that's unchanged? And also within that expectation are you including pre-payments for the Challenger and Eastern European orders? My second question was really about capital allocations. I think on full year results you've said that some of your M&A targets were quite close. Can you give us an update on any of these M&A processes that you're looking at?

[0:27:24] Helmut Merch

Yes, sure David. So yes I can confirm our 3% target on cash flow ratio and I would remind you that we have a uplifted mid-term range for the cash flow ratio. That is 3% to 5%, but this is not the case for 2021. So we are more at 3% level than the 5%, that is right. If we were lucky to get a bigger contract from Eastern Europe, then we have a good chance to go above the 3% but only to get some flavor for the Challenger here, we will get no big down payments. We started with some small so-called mobilization payments, and therefore there will be not a very large positive impact on pre-payments.

The second issue regarding M&A targets, if you refer to the press article and the interview of our CEO, he mentioned that we are looking to some assets of the Swiss Group RUAG, that is right. But we are not steering and leading the process, we are part of the process. The process is being led by the RUAG management. Therefore, we have to align with their time schedule but I guess that those assets, simulation assets and also the small caliber ammunition asset, these processes should be done during 2021.

[0:29:34] David Barker

Fantastic. Thank you.

[0:29:36] Helmut Merch

Welcome.

[0:29:41] Operator

The next question comes from Joseph Ayoola from Morgan Stanley. Please go ahead with your question.

[0:29:47] Joseph Ayoola

Hello, good afternoon. Thank you for taking my questions. I just got a couple from my side. The first was just on Eastern European IFV tenders. I think you previously highlighted there were two countries currently involved here, Czech Republic and Slovakia, could you maybe give us any color in terms of how you see that going and in terms of the conversation, you are having there. And on the long side of that, I think, looking more broadly at the region, have there been any change in customer conversations and demand given some of the recent geopolitical tensions. That is my first question.

My second question will just be on Weapon and Ammunition where you have a very strong Q4 and obviously, clearly a strong Q1 on the margin side. I understand there are some tailwinds there from export deals but if there is anything else you'd like to highlight in terms of potential drivers on the margin side. Thank you.

[0:30:46] Helmut Merch

Okay, coming to the first question regarding the demand of Eastern European or Central European countries, I only can confirm that we are participating in two large tenders that is A, Czech Republic, and B, Slovakia. And here, we have the following situation.

In the Czech Republic, we have a party of three corporates participating in this tender that is BAE, GD, and Rheinmetall. iIn Slovakia, the competitor's landscape is a little bit larger. Here, we have at least Hanwha additionally in the bidding process. But I think we are very confident that we have a good chance in both processes because the first decision has been made by Hungary and there is also some influence among the Eastern European countries. And I guess especially the Czechs, have some preference for German equipment.

But for the time being, I can say that trials and tests are under their way in both countries, tests in the Czech Republic have been scheduled from the end of April to mid of June and the test and trials in Slovakia will also hopefully be finalized at end of June, so there could be a real chance that we get some more information for an upcoming decision during H2.

One other issue I think is around LAND 400 Phase 3, here very important elements of the necessary trials have already been passed and fulfilled. And also here, it could be that we get some early indication in which direction the Australian customer will decide also during H2. So all three projects look promising.

The other thing is – what we can mention is that the Italian government showed also first interest in the Lynx. They have to replace their existing infantry fighting vehicles, the Dardo, and also the Italians are looking for a joint venture or a strong corporation but this project is in a very, very early stage but this is also to underpin that our present product portfolio in vehicle systems is a very strong one.

On the other side, we have given also our offer for the first phase of the Bradley replacement. This is a digital study here, a party of six to seven corporates are in this process and now after onboarding L3Harris, we have a very strong American-German team, and therefore, we are very confident that also we can be part of the first phase which is around USD50m.

Coming now to your second question, Weapon and Ammunition, yes, we have some lift off of existing export bans but one important ban is still in place, this is an export ban to Saudi Arabia from South Africa and also from Italy and also from Germany. But for some other Middle East countries the ban was lifted especially from South Africa, so we were lucky to deliver some parts of contracts which has not been done last year.

But also to give you an overall flavor, if we are selling vehicles with weapon and there is a strong demand for corresponding ammunition, and therefore I tried to give you some indication that a consequence of the Lynx Hungarian contract, we are actually negotiating a huge ammunition contract for the Hungarian Lynx. Therefore, we are pretty confident that we will see a nice overall demand for our Weapon and Ammunition business. And as you know, here we have a nice vertical integration, so the profitability will also show a good development in the upcoming years.

[0:36:59] Joseph Ayoola

Great. I appreciate the color there. Thank you.

[0:37:01] Helmut Merch

Welcome.

[0:37:05] Operator

Next question comes from Sebastian Growe from Commerzbank. Please go ahead with your question.

[0:37:11] Sebastian Growe

Yes, high, good afternoon, everybody. Hi, Mr. Merch.

[0:37:13] Helmut Merch

Hi.

[0:37:13] Sebastian Growe

Quickly, one, the guidance to start with and the trading update if I may. The significant growth, I think the comparisons in Automotive, or for the former Automotive operations, they obviously are pretty low. My question would thus be what are you expecting the defence part of the business where obviously you are running gains pretty high comparison. So just to clarify a bit on the significant growth and how it would cascade down in the two activities.

[0:37:41] Helmut Merch

Yes. So the major part of the growth is definitely coming from Auto. So I give you some flavor, sales in Q2 2020 was around EUR1.16b and for Q2 2021, we expect the range of EUR1.3b up to EUR1.4b. So if you take the midpoint, I think that is not as bad. So we will see a slightly weaker Q2 in Defence due to the high comps last year and we see the organic growth in the former Automotive segment. That is for sure.

[0:38:35] Sebastian Growe

Yes, okay. And then another question around Defence and just to follow up on the previous caller's question on Weapon and Ammunition, South Africa, I think you have been pointing to the lifting in export ruling, I would assume that this goes especially for you as this is very, important hub. Where do we stand in terms of getting back to sort of normal after the explosion that you once experienced? From my understanding, there are some sort of low fruit, sorry low hanging fruit, so is there a way up to the kind of full utilization? Am I understanding correct or what to think of this situation?

[0:39:10] Helmut Merch

Yes, we are already back on track since mid of last year so operationally, we have reinstalled the old status but on a more modern technical level. So in case we were allowed to export to all these countries, then I think we would've seen earlier a positive impact. So in Q1, we saw some first positive impacts, we also had a positive impact on the operating result but we are still a little bit away from 100% utilization rate. But operationally, we are fully back on track.

[00:39:59] Sebastian Growe

Okay. That's helpful. And then moving on to materials and trade, you mentioned I think in your introduction that you had some safety stock building. Is there any risk that this is pulled off, snapping back either. i.e. the growth in Material and Trade will be somewhat lower because some of the customers have just built that very safety stock or what the trajectory or what you think?

[00:40:19] Helmut Merch

No, I think it's also only a matter of safety and security of supply. I guess that the strong demand, especially in our aftermarket business will stay also for the upcoming quarters. So here I have not any worry.

[00:40:47] Sebastian Growe

Okay. And then the last question I would have is what's for Materials and Trade. And you mentioned that new customer project almost accounted for a hundred percent of the booked business or 96 percent I think what you phrased there in the press release. So this thought of going better than plan, so when you had the strategy update early February, and we're talking about new fields of application for part of your product in the form of Automotive business, and then picking new end market. Can you just update us in that process and where we stand?

[00:41:15] Helmut Merch

Yes, here we have not corresponding sales. We are just building up working groups. We are in the first phase of working on new products. We are elaborating on various markets. So there we have no positive impact on the top line. We have some impacts on the costs, so on the bottom line in order to prepare. My personal guess is that we will not see major impact before H2 2022 for new civilian applications.

[00:42:03] Sebastian Growe

Okay. And how should I then understand this? New customer project that just to underline that you have really great appetite for your product or sort of …

[00:42:10] Helmut Merch

Yes, we have won additional customers which are looking after our products, so we expand our existing footprint in the market, especially in the US.

[00:42:28] Sebastian Growe

Okay. Okay. Okay. I get the message. Thank you very much.

[00:42:32] Helmut Merch

Welcome.

[00:42:37] Operator

The next question comes from Alexander Hauenstein from DZ Bank. Please go ahead with your questions.

[00:42:44] Alexander Hauenstein

Yes, hello Alex Hauenstein from DZ Bank. Thanks for taking a question. I have two, actually. Hello, first of all at the beginning of April, there was some talk in the press and also via internet that the German Finance Minister, Mr. Scholz is about to hand in a proposal for a defence budget actually declining beyond a peak in 2022. So meaning from 23 onwards there, he would hand in a proposal to plan with significantly lower budgets compared to what the Bundeswehr was asking for. So my question is, is this only an SPD pre-election talk to please the voters or are there any further pushes behind the scenes to reduce budget actually? I mean, we all understand the need, but my question is a bit, has this attempt made it into serious discussions and the article actually mentioned that many big projects being at risk, even in case of a flat budget, which in fact would mean a decline for material budgets, as personnel costs will arise due to the link of wages to inflation. Can you update us on that one?

[00:43:56] Helmut Merch

It is a discussion in the press and Scholz gives some comments on this, because Mrs. Kramp-Karrenbauer wants a lot more than the actual ceiling of roughly EUR50bn and this was a possible answer to their additional requests, but I'm with you, that is a pre-election discussion. We actually do not know whether Scholz will be in the future government and therefore I actually would say for 2022 we are more or less on the safe side and the budget discussion around 2023 and 2024 will be done by another government during 2022. And therefore, I beg you for your understanding. I have not a glass ball in my hand. We will see what will happen. I just refer to the statement of Mrs. Merkel yesterday that she is still committed to the higher share of defence spending i.e. 2%. She will not be further part of the government, but I think she has also expressed the position of the Christian Democrats and therefore I am not worrying so much. There is a strong need on the European side to invest more in the safety and security and the ongoing pressure from the US government is still in place. Here we have seen no change after Trump resigned and Joe Biden took over. So I think A, we have a strong order backlog. We have this additional shadow backlog, and now we are running for the next two or three years. And I think we have so many international demand that in case that will be some interruption of spending on the high level for one or two years in Germany, this will not cut our growth story.

[00:44:45] Alexander Hauenstein

Yes. Understood. Okay. Thanks for the updating. I’ve gotten how you think about it. Actually, my next question would be how do you adapt for the microchip shortages? I mean, I understand so far it might be only an Automotive related issue for you, or is there even some issue for Defence to come potentially and can you actually exclude any spillover effects due to the Defence, or is this crisis gets more serious, then it's also interesting or are you sourcing completely on different ways?

[00:47:18] Helmut Merch

A, we are sourcing on different ways. In case we have a chance of bundling, then we do it. But the Automotive part has actually a slightly higher exposure to the shortage situation. And therefore we are closely monitoring our supply chains for the last 12, 15 months with the beginning of the pandemic. For the time being, I have to admit we only see some low impact on the Automotive divisions.

[00:48:01] Alexander Hauenstein

But more and more of the Automotive guys, we hear that they're thinking about producing either different stuff, or let's say using less electronic microchip related and products in there. So would that be also a kind of an option for you to come? Probably not.

[00:48:20] Helmut Merch

No, not for theshort time. This could be a midterm scenario, but I think nobody is able to switch it in the next month. And therefore, I would assume that we would see more European factories in various respect. But this will take time and we have qualified products with our customers and changing only some small elements within our products will not be accepted by the customer.

[00:48:58] Alexander Hauenstein

Understood. And there's no impact on the Defence side. I understood that, correct. Is that right?

[00:49:05] Helmut Merch

Not what I see actually, but as you know, last year, nobody saw this chip shortage coming. Now everybody's talking about what will happen in Q3, in Q4. I do not know, but for the time being, we have not seen similar effects on the Defence side.

[00:49:26] Alexander Hauenstein

Okay. Very clear. Thank you.

[00:49:34] Operator

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

[00:49:40] Sash Tusa

Thank you very much. Good afternoon.

[00:49:43] Helmut Merch

Good afternoon.

[00:49:43] Sash Tusa

I just have a quick question about the UK challenger upgrade program. Firstly, the value that you're putting into the likely contract seems to have fallen a little bit. I think initially you thought it would be closer to EUR750m, you're right and it was like EUR650m. Is that a reduction in the number of vehicles you would expect to be converted or is it a reduction in scope elsewhere?

[00:50:15] Helmut Merch

That is an interesting question. I cannot answer as such. I guess we have some re-scoping. This is what I can remember, but I actually do not know what was the original plan regarding number of vehicles and what is the last figure. But I think the UK MOD will shortly able to give some comment on this, I would assume. [IR Comment: Press release on May 10th 2021 confirmed the order value of 770 Million Euro net, the cut of vehicles was already included at an earlier stage, discrepancy was due to different currencies and VAT]

[00:50:51] Sash Tusa

Okay, thank you. And also you talked about how sales of vehicles or with weapons then dragged through ammunition contracts, would it be right to assume then that the UK contracts for ammunition for the challenges will come along later because clearly the UK have none .

[00:51:12] Helmut Merch

Exactly. Exactly this will happen.

[00:51:17] Sash Tusa

Right. Thank you.

[00:51:19] Helmut Merch

Welcome.

[00:51:23] Operator

Next question comes from Christoph Laskawi from Deutsche Bank. Please go ahead with your question.

[00:51:30] Christoph Laskawi

Hey. Yes, thank you for taking my question. Really only two follow ups. First one will be on autos, the EUR25m, EUR30 that you set as negative impact from this semi shortage. Is it just relating to the funds that you cannot get, or is it more the OEM's canceling volumes that you initially expected?

[00:51:52] Helmut Merch

It is both. It is both. Yes, and therefore it's a very interesting question. In some respect we can deliver, but the customer will not pick up the goods from our factories and in some respect we have not the chips I already mentioned, we are still missing 400,000 chips with the original equipment from our sub-supplier was around 800,000 and all of a sudden he said he could only deliver 400,000. So this are both sides of the story. Yes, customer is not able or is not willing to accept and for some parts we are not able to deliver. But I have not the share of these two different sides of the medal.

[00:52:58] Christoph Laskawi

No, that's fair enough. Is there an opportunity to reshuffle what you get from the supplier in the sense that there must be customers asking which product pickup and others declining?

[00:53:10] Helmut Merch

Yes. This is what we intend to capture, all this probably to some extent in the second half of this year. We do not know, but anyhow, we are prepared and there are some voices in the market which are saying that Q3 will show some relief. Other market participants said that this would be a situation until 2022. I do not know who is right and/or who is wrong, but I think in this respect the market will reposition itself. There is still a chance to get some chips with a good relation to the sub-suppliers, but actually now for Q2 we have to live with the mentioned situation.

[00:54:24] Christoph Laskawi

Understood. The second question will be on defense, more or less. I mean, looking at steel, for example, which is in tight supply and other raw metals as well, I would assume you're fairly nicely stocked up. So there's no risk for production of vehicles and other parts in that division, or are you seeing potential upcoming shortages in, for example steel for the business?

[00:54:52] Helmut Merch

No, that is not the case. Also the increase of steel material prices is not an issue which worries us, because the share of steel price in the overall price of a tank is minimal. Therefore, this would be not an issue. But always underlining that if our actual view, what will happen in three or six months, I really do not know. But I think we are preparing ourselves. We’ve made some safety stocks, but I think we are closely monitoring and tracing the situation, but we have only a little influence but we do the utmost that we can, actually.

[0:55:55] Christoph Laskawi, Deutsche Bank

Thank you. That's it from my end.

[0:55:57] Helmut Merch

Thank you, Mr. Laskawi.

[0:56:03] Operator

The next question comes from Chloé Lemarié from Exane. Please go ahead with your question.

[0:56:09] Chloé Lemarié, Exane

Yes, good afternoon. Thank you very much for taking my question. I have two, if I may. The first one is a clarification on your Automotive businesses. You mentioned your EUR25m to EUR30m headwind on sales from the chip supply issue. Can we take this as the absolute sequential drop in the overall sales for those businesses? Or could you have some offsetting impact that will limit this?

[0:56:34] Helmut Merch

That is a tough question, because now we have seen our April figures, April was not as bad, but a little bit lower than the average of Q1. Therefore, I said that we saw some EUR10b of impact due to the chip situation. If we have a chance of some offsetting sales, then we were lucky, but I think the overall view on Q2 is not as bad. But I think it is fair to say that we will see some small reduction compared to Q1. It is too early to say if we can offset the impact from the chip shortage.

[0:57:29] Chloé Lemarié, Exane

Okay. Thank you. The second one would be regarding on your comments on potential Italian JVs. The press actually mentioned JVs with two potential Italian defense companies. My first question on there would be, is this an initiative from the Italian government? Or is it one that is actually coming from you? And can you just help us understand the rationale and if it would require a matter of investment from your part or just cloning some assets with the company?

[0:58:00] Helmut Merch

No, it is an initiative from the Italian government, because also they have the need to modernize their armored fleet. And looking at the Lynx, that it is actually the best value for money being offered in the market, and therefore we have first talks with the Italian government. Because every country wants to maintain a sensible workshare in their own country, they also have the idea of forming collaborations or cooperations or even a joint venture. We are open for those kind of initiatives, but anyhow, at the very end they must make sense for us. We do not like to work in a minority position. If we are giving our technology, we would like to have a fair share of the game.

[0:59:12] Chloé Lemarié, Exane

Okay, very clear. Thank you very much.

[0:59:17] Helmut Merch

Welcome.

[0:59:19] Operator

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

[0:59:25] Christian Cohrs, Warburg Research

Yes, thank you very much. Good afternoon. Maybe just a quick follow-up. If I'm not mistaken, you said that you expect sales of EUR1.3b to EUR1.4b in the second quarter. So just for clarification, does this still include the Pistons business? Or is this without? Yes, that's maybe the first question. Because Pistons will be recorded under Discontinued. So did you factor this in or ...?

[0:59:58] Helmut Merch

Yes, yes, that is excluding the Piston business.

[1:00:04] Christian Cohrs, Warburg Research

So EUR1.3b to EUR1.4b including Pistons?

[1:00:07] Helmut Merch

Excluding.

[1:00:8] Christian Cohrs, Warburg Research

Okay. Then maybe a follow-up on our last call, the Saudi Arabian contract where you're not allowed to deliver. You said that you are seeking compensation from the government. Can you maybe provide us whether you've been successful or whether there other possibilities occurred to solve this issue?

[1:00:35] Helmut Merch

Yes. So firstly, we have installed our legal claim towards the German government. On the other hand, we are also obliged to minimize the damage and here, that is for sure, we are looking for alternatives. As the trucks have been designed for countries, which have sunny and dry weather, we are looking for countries in this region. Luckily, we have found a couple of countries which show interest and now it is a matter of negotiation and bargaining. I will not exclude that we could sell some or all trucks during the next 12 months. Anyhow, there will be a damage left which will be a basis for further claims to be compensated by the German government. So we will not give up our legal position.

[1:01:57] Christian Cohrs, Warburg Research

Okay, understood. Then the last question, you stated that you expect free cash flow to sales rather at the 3% line. Can you maybe help us with what to expect or what to pencil in for this year's CapEx? The first quarter was slightly down. But I remember that you actually intend to spend more since you ramp up factories. Is that correct? And maybe can you provide us with a range?

[1:02:24] Helmut Merch

Yes. So last year we had some CapEx of EUR200m in Defence and this year I would assume that more or less 10% higher CapEx. So a maximum EUR220m. In Auto it is more or less the same size. Here we had a CapEx of EUR95m and our actual expectation is around EUR120m to EUR125m.

[1:02:52] Christian Cohrs, Warburg Research

EUR120m to EUR125m. Does this include right of use? Or is this just your own cash out?

[1:03:00] Helmut Merch

No, that is our own cash out.

[1:03:04] Christian Cohrs, Warburg Research

So EUR300m, was that actually then sums up to EUR340m?

[1:03:08] Helmut Merch

Yes, that would be I think the maximum, after roughly EUR300m last year.

[1:03:15] Christian Cohrs, Warburg Research

Okay. Thank you very much.

[1:03:17] Helmut Merch

Welcome.

[1:03:24] Operator

At the moment there seem to be no further questions. Ladies and gentlemen, if you want to state any further questions, please press 9 and star on your telephone keypad. There is one more question from Christopher Hallam from Goldman Sachs. Please go ahead with your question.

[1:03:49] Christopher Hallam, Goldman Sachs

Hi, good afternoon, everyone. Just one last question from me. On UK Boxer, currently the plan is to produce roughly one vehicle a week. But given the recent integrated review and the cancellation of Warrior, it seems as though that production number might need to move up quite significantly. So I was wondering whether that's a conversation you're having with the customer? And what flexibility you have in RBSL at the moment to operate at a higher production rate before you start to hit capacity limits?

[1:04:16] Helmut Merch

Yes. A good question, but I think it is a little bit early in the process. We actually are preparing Telford especially for ramping up a production line. So I think we will see not a real impact on our top line in 2021/2022. I guess it is a good question to put again on the table at the end of this year.

[1:04:49] Christopher Hallam, Goldman Sachs

Okay, very clear, thank you.

[1:04:51] Helmut Merch

Welcome.

[1:05:00] Operator

There are no further questions.

[1:05:04] Helmut Merch

So then I thank you all for participating in our Q1 call. Thank you, stay healthy and see or hear you at the latest within our Q2 call in early August. Thank you, bye-bye, have a good day.