Rheinmetall AG
Investor Relations
Conference Call FY 2019
Transcript

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Rheinmetall AG Conference Call

00:00:01 Operator

Good afternoon ladies and gentlemen and welcome to the Rheinmetall AG conference call regarding the FY 2019 results. 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 Armin Papperger.

Armin Papperger

Thank you very much. Ladies and gentlemen, Thanks for the introduction and a warm welcome to everybody. My colleague Helmut Merch and I will walk you through the FY and Q4 2019 earnings release and we will be happy to take your questions afterwards. As a reminder, please take note of our legal disclaimer on the following page. And now let's start with the highlights of the fiscal year 2019 on page no. 3.

The group delivered an excellent set of figures in 2019. New record levels were achieved. Meaning that sales, operating result, cash generation and shareholder return have marked new highs. This is definitely a remarkable operating performance, but we must not forget that our two segments developed very differently. I will come back to this later. Probably the most interesting KPI is our future oriented order backlog, which has crossed the 10 billion Euros threshold for the first time, and stands now at about €11bn, an increase of almost 30% compared to last year. This sets the base for growth in the next years especially in Defence. Please follow me now to page no. 4.

2019 has been a very difficult year for Automotive in a particularly challenging environment: Trade wars, never ending discussions around Brexit and insecurity regarding the speed and magnitude of the powertrain transformation were dominant topics. Before Corona started to hit the headlines, discussions were centered around the de-carbonisation of our society, including city bans for diesel. Automotive was not able to escape this negative development and in fact was strongly affected by a negative sales dynamic of some of our customers. Sales dropped almost 7%, slightly more than the benchmark of global Light Vehicle production. Weaker sales volumes translated into lower margins due to negative leverage. Our cost management measures helped to mitigate the further decline of our profitability, but the margin still recorded a decrease of almost 2.2% to 6.7% comparing with 2018. On the other hand, we were able to achieve a nice improvement of our cash flow as a result of careful working capital management and diligent capital expense execution by €47m to €73m.

Please turn the page for the highlights of the Defence business: The development of the two segments could hardly be any more different. Defence enjoyed a very favorable market environment with a further rise of defence spending in our most relevant markets. Sales grew nicely to about 3.5 billion Euro only held back by more restrictive export regulations, which accounted to an impact of € 90 million in 2019, eliminating almost 3% of growth. High utilization and a favorable sales composition drove margins up to 9.8%. The total operating result amounted to a record level of €343million.

We were again very successful to win new orders like the UK boxer contract or the VJTF upgrades and trucks for the German armed forces. Currently, we are participating in tenders for almost €10bn for infantry fighting vehicles globally. For the first time, backlog has crossed the 10billion threshold. A lot of the Q4 order intake is actually set for delivery in 2020, including the just mentioned 1.000 trucks with a gross value of almost 400 million Euros. Go to page 6 now.

Earnings per share surpassed previous year's result and came in at 7.77 Euro, an increase of 9%. Special effects per share were significantly lower and accounted only for 16 Eurocent compared to 44 Eurocent the year before. The key driver for the underlying EPS increase of 95 Eurocent was the buyback of our tactical activities in RMMV, which accounted for 59 Eurocent. I am pleased to inform you that we propose to the AGM an increase of the dividend by 14% or 30 Eurocent to 2.40 Euro, representing a payout ratio of around 31%. This concludes the part of the presentation and I will handover to Helmut Merch, the CFO of the company.

[0:05:50] Helmut Merch

Thank you, Armin and good afternoon, also from my side. Group sales increased in total by 1.7% to 6.255 million Euros, supported by favorable currency and some M&A effects, the latter predominantly from legacy business in our new Joint Venture with BAE in the UK. From a business perspective, Defence accomplished to overcompensate the sales decline in Automotive. Operating result exceeded for the first time the 500 million Euro threshold, an increase of 2.9% or 14 million Euro, leading to a slightly improved operating margin of 8.1%. Special items related to the settlement agreement with former board members as agreed by the AGM in May 2019 increased EBIT by 7 million Euro to 512 million Euro.

Please now turn to page 9. The balance sheet is quite robust and our financial position is rock solid. Our investment grade remains unchanged, net debt is low and our credit KPI are very solid. The extension of the balance sheet was mainly caused by two drivers: The low interest environment stressed our pension position again, which increased by roughly 200 million Euro, of which 149 are impacting our equity in the reporting line other comprehensive income. The effect resulted from the necessary reevaluation of our pension liability due to the lower discount factor especially in Germany and Switzerland. Our contract liabilities increased by roughly 300 million Euros due to received milestone payments for major projects. Additionally, I would like to highlight that our current liquidity is around 600 million Euros. 90% of our debt are long-term and we dispose of undrawn credit facilities of around 400 million Euro.

I continue with the details of our operating free cash flow development on page 10. Our operating free cash flow was again very back end loaded. The last quarter generated an operating free cash flow of roughly 650 million Euro, even 140 million Euro above the previous year quarter. However as you can see from the chart, this is in line with our long-term pattern. The key moving parts of our cash flow bridge were: Lower D&A, as the previous year included impairments of 42 million Euro; lower CTA funding of only 20 million vs. 40 million Euro in 2018;

strong working capital improvement on receipt of milestone payments and an adverse effect of higher tax payments. The high milestone payments underscore our recommendation to look at operating free cash flow on a rolling 2 or 3 years approach.

Please now turn to page no. 11. Automotive started to monitor capex early in the year and was able to adjust spending by almost 20% from 142 million Euro to 115 million Euro in order to reflect the economic development. Our capex to sales ratio eased slightly to 5.2%. The main driver for the capital expenditure in Defence were mainly renewals of lease agreement under IFRS 16 especially for Germany and Austria and the increase of capitalized development cost reflecting higher R&D activities in all three divisions. Key driver for increased capitalized development cost were the Lynx which is currently tendered in 4 countries and the next generation of trucks.

Moving on to page no. 12. Automotive is facing a situation where a variety of different propulsion types have to be addressed properly. We are developing new products for internal combustion applications, like the electric vapor pump and at the same time develop products for new propulsion systems like fuel cell or activities for micro-mobility. These parallel activities are the main driver for the slight increase of our R&D spending from 193 million Euro in 2018 to now to 210 million Euro. The share of self-financed R&D accounted for 6% of sales and is expected to remain on this level for the mid-term. Defence reported an almost stable absolute level of R&D activities of 145 million Euro compared to 143 million Euro in the year before, but a slightly decreasing relative share of 4.1%. We expect to see a peak in R&D spending in 2020, before the relative share returns to this year's level and falls even below in the mid-term.

For the presentation of the Q4 results please turn to page no. 14. As already guided during the Q3 conference call, Q4 was marked by a sharp sales decline triggered by a number of ramp downs. The effect from the GM strike combined with general Light Vehicle market weakness and a drop in our truck related sales.

All in all, segment sales declined by roughly 13% and ended at 637 million Euros. Q4 ramp effects of minus 25 million Euros represented the vast majority of the annual net negative effect of now roughly 30 million Euros.

The operating result decreased accordingly with the additional burden of the malware related cost and the quality issues in our Czech operations. This resulted in a margin decline of 330 BPS to 6.2% and left our operating result at 40 million Euros, a reduction of 42% compared to last year. The operating free cash flow almost doubled from 42 to 81 million Euros. The reason for this positive development were the efficiency gains especially in working capital management, which contributed the most and a capex reduction of 16 million Euro.

Now please move to page 15 for the Division highlights. Mechatronics´ Q4 sales dropped by 16.7% to roughly 360 million Euro. Ramp downs with Light Vehicles and truck customers created the biggest impact, followed by lower European Diesel demand. The GM strike hit the division with a high single digit million effect. Results came down by 42% to only 25 million Euro as a result of negative leverage. Hardparts' Q4 sales were hit heavily by the GM strike in addition to weak end markets and ended the quarter 11.6% lower at 206 million Euro. The result decline was more pronounced, because of lower at equity results from our German Chinese Casting Joint Venture. Aftermarket experienced a contrasting development and reported a sales increase of 7% to 92 million Euro with a corresponding result improvement of 11% to 10 million Euro. A favorable sales mix was supportive.

Join me now for the presentation of sales split on page 16. Aftermarket was the only exception with a positive sales development in Q4. All other businesses reported heavy sales declines. Ramp downs in all fuel types and in Light Vehicle as well as Non-Light Vehicle business slowed our sales beyond the general market weakness. While Truck sales were still supportive in the first nine months, the strong decline in Q4 drove the Full Year sales growth into negative territory. Other end markets did not demonstrate any resilience either.

Please turn to page no. 17. In 2019 Diesel lost 5 %points market share in the European Light Vehicle market year over year. This development has also left a mark in our sales. Diesel related products experienced the single biggest decline, accounting for minus 3% or roughly 90 million Euro lower sales. While truck sales were still positive in the first nine months, the last quarter left a clear skid mark and turned the whole year negative. Unfortunately, the other business activities were not able to compensate this trend.

Last, but not least you find the details of our activities in China on page no. 18. Q4 was the first quarter in 2019 with market growth in China. However, we were able to outperform the market and grew our sales by 33% or 82 million Euros to 330 million Euro. We concluded 2019 with an annual growth rate of 15%. We were very successful with the introduction of new innovative pumps like the electric vapor pump and the diversification of our business to new markets like the 5G antenna casting. From an earnings perspective, the positive development was held back by startup cost for new products and increased depreciation.

Let‘s start now with the results of our Defence business on page no. 20. Q4 delivered a fantastic performance. Order intake almost tripled to 3 billion Euro and including 700 million Euro for 2020 sales. Sales grew by 5.5% to 1.324 million Euro and even topped last years' strong performance in the fourth quarter. Operating result rose by almost 20% to 210 million Euro, generating a margin of 15.8%. Milestone payments lifted the operating free cash flow to roughly 600 million Euro, a cash to sales ratio of over 40%. As a reminder, we always suggested to look at an average cash-flow over a two or three years period to smoothen such effects as high milestone payments.

Let's now have a look at the divisional performance on slide 21. Weapon and Ammunition Q4 sales were negatively affected by the tighter regulatory environment. The impact from export restrictions that we put at risk for 2019 in our Q3 call, unfortunately increased by further 20 million Euro and accounted now for 50 million Euro in the quarter. The impact came from South Africa. Apart from this, operating result increased by 6.5% to 114 million Euro on the back of an excellent order execution. Electronic Solutions reported again a solid growth of 5% to 363 million Euro and Q4 accounted for almost 40% of their annual sales. Operating result declined slightly by 6 million Euro due to an unfavorable product mix effect. Vehicle Systems lifted sales by over 20% to 608 million Euro. The main driver for this increase and the improvement of the operating result was the greater share of higher margin tactical vehicles.

Please turn now to page no. 22. For the regional analysis, we switch briefly to a full-year view. The order intake is clearly dominated by the large order for vehicle programs like Land 400 Boxer in 2018 for Australia. 2019 included the MIV Boxer for the UK and the German orders for the trucks and the VJTF programs. So our so-called home markets Germany, the UK and Australia played an important role last year. In the sales breakdown, home markets accounted for almost three quarter of sales and their share rose from 69 to 74%. For the first time, we held orders for more than 10 billion Euro value on our books. This is a fantastic record and builds a solid base for growth for the mid-term and even beyond. The lower backlog share of countries outside our home markets, such as the MENA countries, reduce our export risk profile for future deliveries.

Please move now to p. 23. Q4 order intake was dominated by Vehicle Systems with strategic orders for the UK Boxer and 1.000 trucks for the German armed forces, the latter to be supplied until the end of 2020, materially narrowing the order gap to achieve our 2020 sales target. Almost two thirds of our record backlog of 10.4 billion Euro accounts for Vehicle System programs. The order coverage for 2020 is more or less on a comparable level with the last two years.

This now closes my presentation and I will hand back over to Armin for the outlook.

Armin Papperger

Thanks, Helmut. We first of all want to go to the corona update where we are at the moment. We in Rheinmetall have immediately installed response teams, so called corona action teams to deal with all the aspects of the corona crisis. In a first attempt, we focused on the well-being of our employees and introduced a variety of measures. In a second move, we investigated our ability to cope with supply chain issues in both segments. As we cannot exclude potential future risk of delays in the supply chain, **but as of today**, no significant disruptions have been identified and all plants are fully operational. In general, close communication with suppliers and customers is of utmost importance at the moment.

Please turn to page 26. The measures that we have taken have helped to contain the situation and keep all functions outside China fully functional. Activities in China have restarted in line with the national crisis plan and we are currently back to levels of about 70 % of productivity. Luckily, none of our about 5,000 people in operations, there were no corona effects of them. However, the ordered production stop will negatively impact Q1. We are expecting a lower at equity contribution from our JVs.

We had five incidents in Germany, one in Italy and also now brand-new one in Austria, but we're able to keep all operations in Defense and Automotive in Europe and America. Our supply chains are stable **for the time** being and we are able to source our inventories and to expedite our products to our customers. **Until today**, we have not observed any negative change of the order pattern of our Auto OEMs, in fact we would rather say that customers are increasing safety stock in Automotive. Defence is continuing to grow in Q1.

Ladies and gentlemen, the world at the moment has a very hard time. If Corona had not happened, we would have expected a slight growth of 1-3% on Group level with a margin of around 7%. We cannot guide for the Corona impact in this very dynamic and disruptive environment. We hope to be able to provide you with a guidance update in due course, earliest with the Q1 earnings release, if the situation has stabilized by then. We have some experience now what happened in China. And the impact in China was four to five weeks and after another two weeks Italy, the business is growing.

With this comment, I thank you very much for your attention and open the Q&A session.

[00:24:42] Operator

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

[0:25:05] Sven Weier

Yes, good afternoon from my side. Three questions please and I take them one by one. The first question is on the automotive business you said Q1 you should probably still be okay. But I was just wondering in terms of the second quarter, how much do you think can your automotive revenues fall and you'll still be around break even? Should we calculate with like a 30% contribution margin or what would be your best guidance on that end? That's the first one.

[00:25:45] Helmut Merch

So Q1 I think we should be clear: Q1 will show negative growth in Automotive and will show positive growth in Defence. Q2 is in these environments still far away, but I think you have to calculate more or less with 35% contribution margin in our automotive business.

[00:26:11] Sven Weier

Okay, that makes sense. The second question obviously is more on the defense side. And when I look at your share price development, obviously the market is now telling us that after all the saving measures of the governments globally, there is no money left for defense. It seems like ... so I was just curious in terms of your Defence business, obviously you have a deviation between let's say more your transactional business and the big tickets in your pipeline. Obviously you've spoke about the 10 billion pipeline for infantry fighting vehicles, so I was just curious on those two items, both on the transactional business. I mean, do you see any disruption there or would you expect it? I mean these are certainly not the first crisis we have, so I would maybe be curious how that went maybe after Lehman and after the Euro crisis. And also on your big tickets, if you look at the countries where they are located, I guess we all know there's Hungary, we still have Australia, we still have a lot of big tickets from Germany. So how would you look at those in the current environment?

[00:27:24] Armin Papperger

Yes. First of all, Armin Papperger. First of all Mr. Weier, we are still in good position with our customers. As you know, we have weekly contact to our customers. Is there an impact from our main market, Germany at the moment? We do not see it because as you know, first of all, the order book is really good and if the German government makes a decision about long-term programs usually these decisions are relatively safe. So at the moment from Germany, we see no negative impact. From the rest of the world also not, in the first quarter, we will have a very good order intake, which continues the story that we had over the last two, three years.

Another big ticket is as you are right, is Hungary. We are in the final negotiation in Hungary, maybe there is some delay at the moment because of the final decision. But I personally expect this all weeks, not month. There is Czech Republic on the big vehicle program. There are some big air defense programs around the world. And there is Australia. One point from the Australian side is that the Australian government is asking us if we can deliver early enough but at the moment we see no signals that they want to cut the budget.

[00:28:49] Sven Weier

And can you remember, I mean, how this went after Lehman and after a Euro crisis, obviously we already had a situation where some countries had some, you know, extra expenses. I mean, can you remember how that went then in those countries for you? Was defense still kind of a higher priority so that it didn't get affected or how would you see the pecking order in this?

[00:29:14] Armin Papperger

We didn't feel a big impact on our business about this, in that crisis. So because if you have a crisis usually defense is more important than if you have no crisis.

[00:29:28] Sven Weier

And then my last question is just for as regards again, I mean obviously when I look at your share price, you've been really hit hard, much harder maybe than some auto suppliers or defense company. So, I wonder what's the additional reason for that and do you also refer this maybe still to the group structure in terms of, you know, combined auto defense and you know, increasing pressure from ESG and what that anyhow change your mind in the long-term? Not obviously nothing short-term, but I think you already mentioned at the beginning of the year, that's for example in the automotive business, the piston business maybe not long-term set and still on but what is your thought why the share price is so extremely weak and much weaker than maybe some of your peers.

[00:30:21] Armin Papperger

Yes, if I look at the figures. So really what happens now in quarter one and what we expect on quarter two, we also have, from my side, I also have big question marks because we have a very, very solid business on Defence at the moment and we made an analysis. We are seen as a full auto company. Yes? And there are some of them which are even worse than we are and some of them are better. But we are on the lower range as an auto company. And I really have, like I from my side, I can't give you an answer if it is a mixture or whatever but at the end of the day, the performance of the company must be there and this is our job.

Our job is to bring the performance back and to hold the company high. And at the moment I see the situation that the company is in relative good shape. The corona crisis, we have a good risk management team inside. We have very short reaction times. We have a daily report about our subs, what about the products coming, et cetera, et cetera. I think we have a very good risk management team. And at the end of the day, I am totally convinced that the company is in good shape and if the

Corona history is over that we can come back and hopefully, we do not make the share price. We only can make the performance of the company, but hopefully then the share price is going then also in the right direction.

[00:31:58] Sven Weier

I mean, you haven't done a buyback for a long time and the balance sheet is in a good shape, but would you still find it inappropriate at the moment to do something along these lines?

[00:32:12] Helmut Merch

I think, Mr. Weier it is not today the time to think about this possible issue. We have to do very operational things and I think to manage the crisis is our first task and if there is a necessity or essential investment regarding a share buyback then we will do our investigation, but it is not the time to decide upon this.

[00:32:45] Sven Weier

Understood. Thank you both and all the best.

[00:32:48] Helmut Merch

Thanks.

[00:32:51] Operator

And the next question from Sash Tusa from Agency Partners, please go ahead with the question.

[00:32:58] Sash Tusa

Thank you very much indeed. I've just got a very technical question about the annual general meeting and hence the payment of the dividend. If you had to suspend or postpone the annual general meeting as a result of corona virus, would that make it impossible for you to pay the dividend or would you find another way to get shareholder approval for the payments? Thank you.

[00:33:26] Armin Papperger

No, it makes it impossible because we have the kick off of the AGM. So we need it.

At the moment we plan to have on the 5th of May to have the AGM. But if something happens or if, let me say the government of Berlin where we have the AGM says, stop, we cannot do it. Yes, we cannot pay the dividend. We have to pay it later.

[00:33:56] Sash Tusa

Okay. Fingers crossed. Thank you very much, Lee.

[00:33:59] Armin Papperger

Thanks Sash.

[00:34:01] Operator

And the next question comes from Sebastian Ubert from Société Générale. Please go ahead with your question.

[00:34:08] Sebastian Ubert

Yes, good afternoon and thanks for taking my question. Sebastian from Société Générale, I would have a follow-up question to that of Sven about the operating leverage and the other mode of business. What is the level that you think you can still manage to be around breakeven and what are the leverage you would assume, if we say 10, 15% drop in sales and you need to start measures in either cutting, not only the temp stuff, but also hitting your full-time employees to maybe provide the basis to not run into losses like we have seen in the last downturn 2009. Thank you.

[00:35:18] Helmut Merch

Okay. So in 2019, you'll see some indication here our sales dropped by roughly 6%. Our operating margin went down by roughly 220 basis points. I could imagine that we could manage a further decline of up to 6 or 7% on the annual sales basis to still be in positive territory, but in case of a sales drop of more than 10% then it would hard to cope immediately with the challenges on the cost side. Actually we are cutting all costs which can be influenced on the short-term. But this is the current estimation.

[0:36:23] Armin Papperger

If we realize all our cost savings potential, we could still manage to remain break even in a 10% [correction Investor Relations to the original statement of 15%] market decline scenario.

[00:36:33] Sebastian Ubert

Okay. Thank you very much for that. And then one follow up question also with regards to the current situation as we have now seen, schools have been closed in Germany and other locations obviously automotive companies shutting down. How do you deal with this and your blue collar workforce in particular, how do you manage that if people need to stay at home to take care about the kids for an unknown time period?

[00:37:00] Armin Papperger

Yes. First of all every of our factories has a crisis team which has singularly checked out what we can do. We cannot take care as Rheinmetall to have, let me say a Rheinmetall kindergarten and others because this is not allowed. What we do is we have on a 50:50 work-base, 50% of the people we send home, especially people with kids we send home, they have home office so they can handle the kids at home. 50% of other people usually who have no kids are in office. The same for the blue collar workers side is where we do not send 50% of the blue workers home, but on the blue collar workers side we have two or three groups in the factory.

If there is an infection of one group that the other group can work for that, that the sales is not dropping down too much. This is a good experience that we made. For example, the welding shop in Unterlüss, there, if you have 150 people, we have 15 people and another group of 15 and a third group of 15 people and so on. And every group is isolated, so if an infection is in one group, we can carry on with work. At the moment there is not a big problem and our HR directors take care about the kids. There is not a big problem that our people are not able to handle the kids because kids have no school. If there are some hot cases or extra cases, we have to take care about that. If they need some, if there are some extra costs, we want to help them in different areas. For example, we brought back people now from South America because we did not know what's going on. We took our influence to bring our people home. But this is case by case what we do.

[00:39:03] Sebastian Ubert

Thank you very much.

[00:39:05] Armin Papperger

Thank you. **[00:39:07] Operator**

And the next question comes from Christoph Laskawi from Deutsche Bank. Please go ahead.

[00:39:15] Christoph Laskawi

Hi Christoph Laskawi Deutsche here. Thank you for taking my question. The first one will be on liquidity. You currently have quite a decent liquidity position. But are you still looking at liquidity preservation measures like cutting capex in the near term? And are you in discussions with the OEMs and your suppliers on what to do with working capital, are OEM's indicating that they are paying on time or are they rather stretching terms currently and the same for you and your suppliers as a first question?

[00:39:47] Helmut Merch

I think actually we have no single signal that OEMs are not able or willing to pay. I think the whole situation is actually quite new, especially regarding the possible shutdowns of factories from the OEM side. So I think it is our first task to look at capex and working capital. On the other hand, we also attempt in some bottleneck products to increase our inventory, enable us to produce in mid-term. I think we are and I just indicated in my presentation, we have a rock solid financial position. We have an actual liquidity of roughly 600 million. We have undrawn bank facilities. We have also a syndicated loan up to 500 million Euro which we also can draw. So I think from a financial perspective I see that we are in a very good position. And we have to look what will happen in the next couple of weeks, but I think it is not wise to speculate about OEMs and their willingness or capability of paying their bills.

[00:41:24] Christoph Laskawi

No, the OEMs are actually indicating that they will pay on time just to secure the supply chain. Just a question on if you see any discussions also with OEMs.

[00:41:34] Armin Papperger

Mr. Laskawi on the other side, what we see is that the OEMs are looking for some restocking. So they build really up their inventories to say if they start again. And at the moment, yes, we have some order, some more orders than we expected because if they shut down two weeks, three weeks or maybe four weeks the factory and if they want to start, they don't want to miss some parts. This is what we see at the moment.

[00:42:05] Christoph Laskawi

And do you discuss like using short-term work or governance measures in the near term as well and do you plan to shut down production say in a week or two as well or will you just run on a very low level, say one shift?

[00:42:22] Armin Papperger

It depends. So we plan, first of all, everything. So there is some very support at the moment and the German government especially gave us the possibility to have a very short term reaction. So we plan everything. If there is not a strong impact from the automotive OEM side, yes. We do not plan on defense side because on the defense side we have a full audit book. So we can work as long as it has no impact on the worker's level that they get ill or whatever we can work. But on the auto side we plan all the things through, but at the moment there is no indication that we have to shut factories down. But week by week we have to look for that, yes. And as I said, I have no glass ball what really happens in two or three weeks. But we have to react, we have to manage the company and we manage it now daily.

Every morning, the top management of Rheinmetall gets a Corona report, a report of our supply chain. And in some areas, and this is also a good example, what I say, because we ask what happens on the ammunition side for example if there are some parts missing. And nitrocellulose for example, is a very important part for ammunition because you can produce no ammunition without nitrocellulose. So I have one year nitrocellulose on stock and this is the reason of our risk management that we have also higher working capital in some areas because it's cheaper to have this higher working capital, then not to be able to produce and we are able to produce. So even if Corona lasts three, four or five months, we are able to produce ammunitions because we have a lot of our stuff on stock. This is what our risk management says.

[00:44:15] Christoph Laskawi

Excellent. And actually was one further question for inventories in defense, that you already answered it right away. The last question would be do you expect any delays on signing contracts simply because you cannot get hold of the right guys in the government right now being potentially involved in other issues? Or would you expect everything to be on track and say fairly smooth also for the order intake?

[00:44:41] Armin Papperger

We will have a delay of I think, minimum three or four weeks because to most of the countries we are, at the moment, not able to fly in. And if I want to sign a contract in Hungary, it is impossible at the moment because we cannot fly in. And therefore we will have a delay of maybe some weeks. My expectation is that we have not a delay of some months or of years, yes? But if there are some weeks I say yes, there will be a delay. It would be unfair if we say no, because as you see, all the travelling issues are big issues at the moment.

00:45:18 Christoph Laskawi, Deutsche Bank

Very clear. Thank you.

00:45:22 Helmut Merch

Thanks a lot.

00:45:23 Operator

The next question comes from Richard Schramm from HSBC Trinkaus. Please go ahead.

[00:45:31] Richard Schramm, HSBC Trinkaus

Yes, thanks. So one question was just covered with the supply chain. So you absolutely see at the moment no risk that critical supplies are running out of shortage here. On the other hand, I think that – or I would like to know from the structure of your backlog, you underlined that Vehicles is about two-thirds. Can you elaborate a bit on how you can then secure the profitability in this mix of structure? Because in the past, Vehicles was always a bit of a weak spot but can we be sure that this is not a drag on profitability going forward here? Thank you.

00:46:26 Armin Papperger

Yes. On the profitability on the Vehicle side, you have seen from the last year that our profitability on the Vehicle side is going into the right direction. So our strategy is that the Electronic Solutions should be around 8%, vehicles also 8%, in good years maybe a little bit better. If you see the whole vehicle systems between 8% and 9% and ammunition, as you know, double digit, 12%, 13%, 14% in that area. This varies a little bit from year to year. What I see at the moment, there is no decline because the vehicle business is going up and we have good vehicle cost rates.

00:47:12 Richard Schramm, HSBC Trinkaus

Okay. Thank you.

00:47:14 Helmut Merch

Thank you, Mr. Schramm.

00:47:16 Operator

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

00:47:22 Christian Cohrs, Warburg Research

Yes, hello. I hope you can hear me?

00:47:25 Armin Papperger

Yes.

00:47:27 Christian Cohrs, Warburg Research

Okay, fine. So yes, just maybe follow up on the Vehicle Systems. I think you made 8.5% margin last year. But I think it is fair to assume that the margin scope is extremely limited. Or do you think – do you see, also due to demand that you can maybe increase prices mid-term so that we can grow even beyond the 9%, longer term? Then a couple of housekeeping items, actually. In your presentation your CFO at various times mentioned that it’s worth to look at working capital on an average two to three years’ perspective. Is this a hint that working capital ratios and also free cash flow aside, what’s a cyclical downswing Automotive could be deteriorate in 2020? Also I was a bit puzzled about your interest expense guidance in the Appendix of your presentation. This was a good cash flow performance and a good balance sheet ratios 2019. You are guiding for deterioration in the interest expense next year. Maybe you can shed some light on that. Thank you.

00:48:42 Helmut Merch

Okay. The first thing, regarding working capital development, I combined it with a statement around generating free cash flow. I think the ability of generating free cash flow is highly dependent on the working capital situation. We have this lumpy situation in the Defence business due to milestone payments anddown payments. We have a relatively stable situation in Automotive. Here if you look into history we have our working capital ratio between 10% to 15% of sales, very stable. And we have some higher working capital, for instance, in the aftermarket business because of our 24/7 business. But I think also 2019 showed that automotive was clearly on track to manage working capital.

So Defence I think here the dependency on payments is still strong and therefore we continuously recommend to look for at least an average of two or three years regarding working capital and free cash flow. So also historically our working capital ratio in Defence differentiated between 25% up to 35% of sales. Regarding interest, here we had some special situation in 2019 which are in favor to this figure of I guess roughly EUR35m. Here the normalized figure we expect for 2020, it will be around EUR40m again.

00:50:42 Armin Papperger

And your first question was of course about the Vehicle Systems. My expectation is that because of the big programs in vehicle systems, over the next years we become more service and spare parts contracts which are profitable. So at the end of the day it is possible, yes, minimum to make also this profit or to grow higher than what we are at the moment. But I'm very happy if we are on a level between 8% and 9% on the Vehicle side.

00:51:10 Christian Cohrs, Warburg Research

Okay, understood. Thank you very much.

00:51:13 Armin Papperger

Thank you.

00:51:15 Operator

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

00:51:21 Joseph Ayoola

Hello, good afternoon. Just one question from me in terms of the Defence business. So could you please give an update on the export restrictions you've seen obviously in Germany, South Africa and Italy so far, and the current status there, particularly on South Africa which seemed to get a bit worse in Q4 in terms of the impact. It doesn't look like the guidance implied that comes back necessarily in 2020. So your expectation in terms of what you think with South Africa in 2020 would obviously be quite helpful. Thank you.

00:51:52 Armin Papperger

Yes. Thank you. So from South African side, it seems to be that there is some light at the end of the tunnel. The South African government agreed to change again this terms and conditions in the export regulations. The process is that we have to wait for another two or three months to bring it into the document. But we hope that in the second half of 2020 exports from South Africa is going back on track.

From the German side, as is noted, this is especially from the Middle East side, especially from Saudi Arabia. Our expectation is from the Saudi side that in April we get a final decision about the trucks. We didn't plan the trucks but if we get a final decision this should be we are able to deliver to Saudi Arabia. This is case no. 1. Or case no. 2, we get money from the German government because they have to compensate it by law and this is very clear. So I spoke with the Minister of Economics and this is very clear, that they have to compensate. Case no. 3 would be another delay, that they go again to court instead of we have to change the decision no. 1 of court but hopefully we get a decision in the first half-year 2020 now from the German government.

The total rules and regulations for export, especially in Saudi Arabia, I think still Saudi Arabia is very hot. The rest of Middle East, especially Oman and UAE, is much better. So there are the first exports where they got permissions. They gave permissions to the German industry, especially also for UAE, but Saudi is still very hot.

00:51:21 Joseph Ayoola

Okay, that's very clear, thank you.

00:53:58 Armin Papperger

Thank you.

00:53:59 Operator

The next question comes from Sebastian Growe from Commerzbank. Please go ahead.

00:54:05 Sebastian Growe

Yes, thanks for taking my questions. Good afternoon, everybody. It’s only one left quite frankly and that’s on KMW, if you have seen any change in the current negotiations, if there’s a greater willingness to push relief things through. Eventually also in light of the corona situation and to just really monitor is on the asset, anything that you might be willing and able to share at this point would be much appreciated. Thanks.

00:54:30 Armin Papperger

No change at the moment. We speak together, we always try to find a way, but no change of the situation, Mr. Growe.

00:54:38 Sebastian Growe

That's, fine. Thank you.

00:54:40 Armin Papperger

Thanks.

00:54:42 Operator

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

00:45:03 Alexander Hauenstein, DZ Bank

Yes, all my questions have just been answered. Thanks for that.

00:54:55 Helmut Merch

Already answered.

00:54:56 Armin Papperger

Okay. Okay, good.

00:54:57 Operator

Okay. Ladies and gentlemen, at the moment there seem to be no further questions. If you would like to state another question, please press 9 and the star key on your telephone now. Okay. There seem to be no further questions.

00:55:21 Armin Papperger

Thank you very much for your time. Thanks.

00:55:24 Helmut Merch

Thank you, bye.