Rheinmetall AG
Investor Relations
Conference Call Q2 2020
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 Q2 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. Please go ahead.

[0:00:23] Helmut Merch

Thank you for the introduction.

Ladies and gentlemen, let me first welcome you all to the Q2 conference call. I hope you had an enjoyable summer so far and that you and your families, friends and colleagues have managed to stay safe and healthy. During the next couple of minutes, I will walk you through the details of our business in Q2 2020 during these extraordinary times and afterwards, the floor will be open for your questions. As a reminder, please take note of our legal disclaimer on the following page. And now let's begin on page no. 3.

Before we start with the Q2 financials, I would like to provide some more details on last week's ad-hoc statement. Obviously, Corona has accelerated some industry trends dramatically. Markets have shown the highest decline for decades. The global Light Vehicle market declined by 45% in the second quarter and is not likely to recover soon. Therefore, we had to revise our mid and long-term market assumptions for our Automotive business. This triggered an impairment of EUR300m. In order to rightsize and to prepare for the right set up of our Automotive business, Rheinmetall has initiated first steps, beginning with the communication of restructuring measures of EUR40m in Hardparts and Mechatronics for coming Q3. I will provide you with some more details on the next two pages.

The impairment charges of EUR300m were posted in the second quarter. As presented on chart number 4, EUR291m out of the EUR300m affected Hardparts. In the past, we already hinted at the challenging situation of the small bore pistons business and this was the focus of the impairment process. This business is highly competitive and expected to be exposed to a structural change in the coming years as mobility transforms away from internal combustion engine. The impairment eliminated 100% of Hardparts' goodwill and reduced the division's asset base by around 50%. The effects in the other divisions are minor.

On page no. 5 you find the details of the announced restructuring package. Rheinmetall announced the evaluation of strategic options for the Automotive segment. The first outcome of this process was presented at the end of July with the announced closure of the small-bore pistons production for light vehicles at our site in Marinette in the US and the corresponding relocation of production to Mexico and Czech Republic in order to optimize our global footprint. Small bore pistons will be our focus in Hardparts with further global footprint optimizations and efficiency programs. An accrual of EUR24m will be posted in the third quarter.

Mechatronics will start a number of different projects. It is necessary to adjust our capacities to the expected market development and this is one of the first steps of the rightsizing exercise. The next goal is to further reduce our combustion engine exposure and therefore Mechatronics will have to realign its structural set up.

Our ambition in Automotive is to remain a competitive tier one supplier with compelling product portfolio for the new mobility and to close the gap that will finally evolve over time with the decline of the traditional combustion powertrain. Mechatronics is a leading technology provider in its field and we are looking to develop new markets from this excellent technology base. Since some of these projects are still early stage, we will only start to communicate after they have reached a certain maturity level. The total Mechatronics' package will be accrued for with EUR16m in the third quarter. Both restructuring packages with a combined amount of EUR40m include a variety of personnel measures. Cash-out for these packages are scheduled to take place until 2022 and we expect corresponding savings of EUR40m up to EUR50m to start in 2022 and will show full effect from 2023 onwards.

Chart number 6 provides you with additional background, how we at Rheinmetall coped with the Corona crisis in Q2. Although we are currently observing an increase of infections and quarantined employees, I would like to state that the still comparably low numbers prove our corona countermeasures right. We were able to take advantage of our excellent China network to source personnel protection equipment and enter into a supply agreement with the German authorities, namely the Army Procurement Office called BAINBW, with an expected value of up to EUR100m this year.

Our cost-cutting measures especially in Automotive were highly effective and translated into a significant improvement of the operating leverage to 27% instead of the forecasted 35 to 40%. The same disciplined approach was applied to our Automotive Capex projects, which came down by 55% in Q2 y-o-y. Last, but not least, we were able to reboot the operations in all our plants smoothly and support our customers during their restart operations. Please turn to page number 7 where I am going to present the financial highlights.

Reported sales declined by roughly 16% to EUR1.239bn in the second quarter. Although Defence achieved an increase of 21%, the dramatic volume drop related to the corona pandemic cut Automotive sales by half. Operating results showed a comparable picture: The volume driven loss could only be partially mitigated by the fast-acting cost cutting measures in Automotive and the significantly improved Defence result. Special items of EUR300m impairment charges and EUR2m other restructuring drove reported EBIT to minus EUR266m. The impairment charges were entirely posted in the Automotive business. As a consequence, earnings per share declined from EUR1.70 to minus EUR5.76. Excluding the impairment effects, earnings per share would have only declined to EUR0.46. Follow me to page no. 8.

The operating free cash flow declined in the second quarter by EUR142m to minus EUR221m. The sharp earnings drop in Automotive was the main driver, while impairment was cash neutral. Opportunistic sourcing in Automotive in order to protect from potential supply chain disruptions and business related increase in Defence drove net working capital. Cautious Capex management in Automotive was already supportive and will contribute even more in the full year as presented on page number 9.

In addition to the extensive cost-cutting measures, Rheinmetall has scrutinized available options for cash conservation. As a result of this exercise, capex will be cut up to 25 or even 30% in Automotive and another 10% in Defence compared to the original budget. In the first half of this year, Automotive was already successful and reduced capex spending by 46% or EUR33m compared to last year. The single biggest driver for the capex increase in 2020 is the non-cash IFRS 16 effect from the recognition of the leasing contract in Q3 2020 for our new site in Australia in the amount of EUR52m. This item we have already explained in the Q1 call.

Please turn now to page no. 10. The impairment charge reduced equity and moved the equity ratio to 26.4%. Net financial debt increased by EUR200m to EUR586m, lifting the net financial debt to EBITDA ratio to roughly 0.9 times. We have no major maturity for outstanding debt in 2020 and 2021. Cash and undrawn credit lines provide leeway of EUR1.2bn up to EUR1.3bn. So financially, we still remain sound and solid. And at the end of this year we should end up again with an equity ratio of around 28%.

Join me now on page 11 for some insights into our Automotive cost-cutting measures. To put it in a nutshell: The implementation of our catalogue of measures contributed EUR55m of savings in the second quarter. We reduced total headcount by 11%, lowered personnel expenses by 23% including effects from “Kurzarbeit” or short-time work of roughly EUR19m and cut a number of other expenses by a total of EUR22m. Some of the measures were applied globally and some were intensified with additional local measures. Without the backing of our staff and employee representatives, we would not have achieved this good result, but the industrial trend accelerated by the corona pandemic required this effort.

Moving on now on to page no. 12. With factories closed under lock-down regulation in many countries, the quarter started very badly, but sequentially improved towards the end as restrictions were lifted. The re-booting of our own operations and the support to the OEMs went very smoothly. Order intake and sales were depressed, in line with our expectations, but the decline of 53% was less pronounced than the market decline of 62% in our relevant markets largely driven by our non-light vehicle business. The reasons for the decline of the operating result were already explained on the previous page as well as the impairment impact. So operating free cash flow suffered from lower results as mentioned and opportunistic sourcing to avoid a disruption of our supply chain. Please turn now to page 13.

All three divisions were hit very hard by the corona-driven volume decline. Hardparts saw additional effects from strong comparables in Q2 2019 due to an equipment sale of EUR14m, which was booked in the reference quarter and lower at-equity result as the recovery of the China Joint Venture was mitigated by the negative contribution of our European casting activity. Aftermarket was affected by the lockdown related closure of the repair shops and the OEM plant closure. Additionally, the consolidation of expenses for our micro-mobility burdened results with EUR3.6m. Join me now for the presentation of Q2 sales split on page no. 14.

All markets were severely impacted by the corona crisis. However, Light Vehicle sales were hit harder and declined by 60%, while non- Light Vehicle sales only contracted by 41%. The severe decline of 58% in the truck business compares to the relevant market decline of 68%. This created a burden to the non-Light Vehicle business, but Aftermarket and other end markets helped to curb the sales reduction at a minus of 41%. Please turn now to page 15 for the details on our joint venture in China.

The recovery of the Chinese market was already apparent at the beginning of the second quarter and we saw that the sales development of our JV was broadly in line with the market. Our specific customer mix was a little bit behind the overall market recovery, as some local OEM with higher share of innovative products slightly lagged the market development. By now, all 14 Chinese plants are more or less back to pre-corona levels. EBIT grew by 31% to EUR21m, and this improves margin from 6.8% last year to 8.3% in the second quarter. Please move on to page no. 16.

While the regional comparison shows IHS Light Vehicle production data versus Rheinmetall sales, we have added a global comparison adjusted for China sales in the center in order to properly reflect our consolidated sales mix. Automotive sales development was globally slightly better than the adjusted Light Vehicle production decline, resulting in an outperformance of 9%. The above-market performance of Automotive was based on the comparably better performance in Europe and USMCA. Now I would like to continue with the Defence segment on slide 17.

As the figures underpin, we could not observe any corona related business slow down, although plants in Vienna, Canada, Italy and South Africa were affected by temporary lockdown measures. But we have not seen in Q2 and do not expect for the Full Year any major negative effects from the corona pandemic on our Defence business. Order intake grew by 50% to EUR752m, which was higher than expected due to the next big ticket from Germany, a first tranche from the framework agreement for load handling systems with an order value of EUR293m. Sales grew to roughly EUR900m, an increase of 21%, including a M&A contribution of EUR26m. Additional support in the amount of EUR35m came from sales that were originally scheduled for Q3, but were brought forward at the request of the customer. Q3 sales will therefore be affected negatively with the corresponding value. The operating result benefited from high volumes and favorable product mix increasing 55% to EUR93m including the above mentioned effects. Special items refer to minor restructuring measures in South Africa. The operating free cash flow in Defence adjusted from minus EUR131m to minus EUR141 because of higher net working capital related to business activities as well as higher capex that rose year over year in line with our full year expectation. Let's turn now the page for the divisional details on page no. 18.

Compared to our Q2 trading guidance we were able to overachieve our sales growth expectations by roughly EUR60m due to the already mentioned effects. All three Divisions contributed to the sales and earnings growth. Weapon and Ammunition Q2 sales increased by 34% to EUR278m. Electronic Solutions grew sales by 11% to EUR224m. Deliveries for VJTF programme and Gladius projects supported this excellent growth. Vehicle Systems reported another strong sales increase of 18% to EUR457m. The sales growth was induced by increased Tactical Vehicle sales, especially Boxer-related sales. The high quality business mix drove results from EUR33m to EUR48m.

On page no. 19, you find the order intake and backlog details. Order intake reported another strong quarter in all three divisions, even higher than we expected because the German order for load handling systems was originally scheduled for later in the year. We are now expecting again a high German order intake in 2020 of around EUR1.5bn. And there is some additional potential in case the stimulus package of German government being already announced will reach also the Defence budget. There will be some chance. Please move on to page no. 19.

The demand of our logistic vehicles is continuously growing and we are attracting high interest from around the world. Apart from Australia, currently signed framework agreements for the HX family of trucks, including protected and unprotected cabins and special feature vehicles like the load handling systems variants, accumulated a total framework value potential of now EUR4.2bn. EUR1.1bn is already invoiced or under firm order. This leaves an expected call off potential of around EUR3bn undersigned framework agreements, which is not yet reflected in our order backlog but could be seen as a figure with a high probability. The German order for a total of 4.000 HX trucks equipped with a load handling system was the latest addition to this list of framework agreements and was signed in Q2 2020. Again, Rheinmetall is able to demonstrate its high technological expertise in respect to additional technical features such as the load handling system and its special know-how in respect to cabin protection: 50% of the vehicles will be equipped with a protected cabin. The first German call off accounted for EUR293m, as mentioned, in the second quarter and covered 540 vehicles.

The consequences of the strong first half performance for the second half of this year, are transparently shown on the chart on page 21 for the sales growth depending on the sales growth scenario. I have already mentioned that H1 benefited from sales that were brought forward from Q3 into Q2 at customer request. Since we are confirming our full year guidance in Defence, the underlying sales seasonality in 2020 differs from previous years. The first semester achieved a remarkable increase of almost 20% and we are expecting the second semester to be slightly below last year's strong performance, which included a record final quarter. This implies that Q3 will see a sales decline in a single digit amount, but this does not come unexpected, just a little bit more pronounced due to the advanced sales in H1.

This brings me now to the end of my presentation with the trading update and the segmental guidance update on page no. 22. Automotive is expected to deliver a Q3 with the following parameters: Sales decline should be significantly less pronounced than in Q2. We are actually expecting a sales decline of around minus 15%. The operating leverage should be around 30%. We refrain to provide a full-fledged guidance for 2020, but we are providing a target corridor for the full year operating result between minus EUR30m and breakeven in a best case scenario. We are expecting the Defence business basically to repeat last year's strong performance in the second semester. We now raise the range for the Defence sales growth to between 6 and 7% and lift our expectation for the operating margin to around 10% for the full year. Obviously, all of the above implies that there will be no second wave and business conditions will not change materially, especially not the production volume growth assumptions in Automotive as forecasted by IHS per August 4th 2020.

Thank you for your attention and now the line is open for your questions.

Operator

Thank you. 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 and the star key again. Please press nine and the star key now to state your question. And the first question comes from David Barker. Please go ahead.

[00:24: 05] David Barker

Good afternoon and thank you for taking my question. It's David Barker from Bank of America here. I've got a few quick questions. Firstly, just on the auto strategic options that you're looking at, obviously you talked about restructuring and the non-cash charges that you've taken. Is there anything else you're exploring in terms of potentially, you know, spinning or selling any of the assets? I think that's something we've talked about in the past, but we've never had a say around as well. My second question is you referenced in your prepared statement about the impact of the German defence stimulus potentially this year. Can you give it a broader overview of what that could mean for Rheinmetall this year and 21 and 22? And then my final question is just do you have any update on the outstanding defence, large defence orders that we were potentially expecting in H2 this year. Thank you.

[00:25:00] Helmut Merch

Yes. Okay, starting with your last question, outstanding defence orders, I give you some flavor when I spoke about our full year's expectations for the order intake from Germany. Actually, we have in the first six months, we got some 750 million order intake and we will more or less make the same amount in the second half of this year. And this will be split among different small and medium sized orders. I think looking to the international scene here, we are in the last phase of negotiation with a possible order intake from a former Eastern bloc country. Here we are offering our newly designed infantry fighting vehicles, the Lynx and this is by far the biggest single order we could potentially see in the second half of this year.

There is a lot of medium and small sized orders that we are going to follow up and therefore there are not any major big tickets, besides the already mentioned . Therefore I think the efforts regarding the Australian tender Land 400 Phase 3, are ongoing, but we do not expect a pre-decision in and before end of 2021. And also there could be some pre-decision regarding a second lot of Puma but the final decision also here we will not get before the second half of 2021. The stimulus package you have mentioned, there are some figures in the media, which range between one up to 1.5 billion for the defence budget and there could be a potential this year for us in the range of 200 up to 400 million Euros, additionally. But this is not finally decided. I think the discussions are ongoing, but this could be a further potential this year.

And now referring to your first question regarding strategic options in automotive, I think now we have made first steps regarding restructuring and I think the next steps will clearly concentrate on Hardparts and therefore I can clearly say we are not thinking of an IPO or a partly spinoff. We are looking for other options but this will be clearly focused on the Hardparts segment.

[00:28:45] David Barker

Fantastic. Thank you very much for your clear answers..

[00:28:50] Helmut Merch

Yes, welcome.

[00:28:52] Operator

And the next question comes from Harald Eggeling. Please go ahead.

[00:28:57] Harald Eggeling

Yes, hello. And basically referring to your write downs in Hardparts, the 185 million, and also trying to align this with your Q3 operating leverage guidance for automotive, could you please elaborate on this because I would assume that you should have some seven to eight million quarterly lower D&A in Automotive. Thanks.

[00:29:26] Helmut Merch

I think we tried to give you some flavor of our expected leverage in Q3. And this is already mentioned, 30%. We came out in Q2 with 27% with the expectation of a slight recovery in H2. I think we have to observe what is or will be the situation regarding cost cutting measures. We went clearly on full breaks in Q2 and therefore this is our latest expectation regarding the development for Q3.

[00:30:20] Harald Eggeling

Okay. Thank you. But run rate for 2021 would this be roughly a 30 to 40 million lower D&A?

[00:30:31] Helmut Merch

I'm just concentrating, I beg your pardon on 2020. I'm not willing and I'm not in the situation to provide a full year guidance for 2021, but you can believe if there is some lever which will come from D&A, then it needs to be shown in 2021, no doubt.

[00:31:00] Harald Eggeling

Okay. Thank you.

[00:31:02] Helmut Merch

Welcome.

[00:31:04] Operator

And the next question comes from Sven Weier. Please go ahead.

[00:31:10] Sven Weier

Yes, hello Herr Merch. Thanks for taking my question. The first one is referring to your Defence guidance of a small sales decline in the second half year on year. When I look at your backlog it's roughly 200 million lower than at the same time in 2019. So is it fair to assume that in the second half you expect the higher share of in for out orders than you had in the second half of last year because you only expect a small decline. I think the backlog would suggest more like 200 million.

[00:31:45] Helmut Merch

Yes, you’re right. Actually we have an order intake gap to cover. I would now say the upper band of our range of around 300 million Euro. Last year, at the same time, we had only a gap of 160 or 70. So yes, we have to bridge another 120, 130 million of order intake to turn exactly into sales in H2.

[00:32:20] Sven Weier

Okay. And based on the pipeline, there is a lot of short cycle stuff in there that will make that happen obviously.

[00:32:27] Helmut Merch

Yes.

[00:32:29] Sven Weier

And then when I look at your EBIT guidance right, I mean I take the 10% literally, then this implies a 10% EBIT decline year on year. So should we really look at this guidance saying roughly 10 or roughly 10 could also be somewhat more than 10, or is it really that you're mix in the second half of last year was so good that it would decline by 10% on the side.

[00:32:51] Helmut Merch

I think roughly, roughly means you look from below or from above to this figure. Here, you are right in your interpretation. But on the other hand, looking what has happened in H2 2019, we came out with a selective operating margin in H2 of 12.7%. Now looking to what we are actually guiding, this implies an operating margin for H2 more or less in the same amount exactly calculated around 12%. So in case there would be a potential of another 70 basis points, then the operating margin could be slightly higher than 10%.

[00:33:45] Sven Weier

Understood. Then a follow up question on the order pipeline, you didn't mention the challenger and the Czech Republic. Is that something you would now expect more on the first half of next year or what's the status on those two projects?

[00:34:00] Helmut Merch

Yes, I think we have a very mixed picture from the Czech side. Early this year there was a clear signal due to corona, they want to delay the decision. Then some weeks later there was a semi official statement. Now they want to stick to the original decision. So the picture is not yet clear.

Therefore my personal expectation is that the final discussion around the Czech procurement will clearly go to 2021. And the situation around the Challenger upgrade is more or less the same. Also here we have different views and different opinions. Some are still looking to a final decision in Q4. Some other are a little bit more cautious and they say, no, there will be also a delay to 2021.

So I hope that in our Q3 call or early November I have a clearer picture on both programs. But for the time being, I would suggest to skip it to 2021.

[0:35:25] Sven Weier

Okay. The final question was just on your KS AluTech business in China. I know it's relatively small, but was just curious. I saw your sales were going down from EUR62m last year to EUR34m in Q2, which I guess for China was already a much better quarter. So I suspect EUR14m out of that is probably the equipment sale that you were mentioning. But even if I adjust for that, it's still a sales decline in the quarter, a reasonably big sales decline. I was just wondering what was impacting that for this business?

[0:36:07] Helmut Merch

Here I have to admit that I have not the answer in front of me. So here I have to quit. I have not the right answer. But in case we will elaborate on this, Investor Relations will give you an update. (IR update: KS Alutech is the German JV with Chinese partners. Here Q2 was still affected badly by Corona; equipment sales were in the consolidated sales in Q2 2019, not in the JV sales).

[0:36:32] Sven Weier

Yes, that's fine. Thank you, Mr. Merch.

[0:36:35] Helmut Merch

Welcome. Thank you, Mr. Weier.

Operator

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

[0:36:35] Christoph Laskawi

Hi, thank you for taking my questions. The first will be on Defence. Just one left on my side. Could you remind us of the order intake target for the full year? And does that actually affect a portion of the Eastern bloc country that you mentioned? Or is it excluding that?

[0:37:08] Helmut Merch

It is always, Mr. Laskawi, it's always a mixture. So my latest expectations, I explained in Q1 was around EUR4bn. And here to some extent there is an expectation for an Eastern country included. But in case, and it is always then a digital decision, in case we will get this contract, and this could be a multibillion contract, we have a clear chance to exceed the EUR4b.

[0:37:53] Christoph Laskawi

Thank you. The next ones will be on Auto. You mentioned the restructuring partially also shifting capacity from high-cost to low-cost, which perfectly makes sense. My question would be, can you do that already for existing contracts? Or would you renegotiate those contracts and the OEMs would essentially agree to the different production location? Or would that be a problem?

[0:38:24] Helmut Merch

It is a challenge, I would say, not a problem. You have to inform your customer and you have to requalify some products on new lines in other sites. But this is not a real problem. But you have to inform – every party has to cooperate, and if you make a forward-oriented communication with a customer, this is a manageable situation.

[0:38:53] Christoph Laskawi

So we shouldn't expect any earnings impact aside from the provisions that you took in Q3?

[0:38:59] Helmut Merch

No. In case we relocate, we first start to pre-produce products to avoid any disruption, and this could be a partially build-up of working capital due to the relocation. This you probably could see in the balance sheet, but we actually do not expect any major turmoil or disruptions, which could have a severe impact on the EBIT line.

[0:39:33] Christoph Laskawi

Thank you. The last question will be on current trading, more or less. We've seen production in Germany for July being down 6% only. This is trending sort of ahead of expectation of most of the supply. Would you say that you see the same activity as your business as well? And it's starting a bit better than you would have thought, while appreciating obviously that September is most likely the most important month of the quarter. And so you can't draw early conclusions, just on one month.

[0:40:07] Helmut Merch

Yes. I think we have experienced the same development. We saw this gradual improvement of the business, having seen by far the trough in April with a minus in the order business of 68%. Then May was a little bit better, but also minus 61%. But especially June was clearly in better shape, with only a minus of 29%. So in Q2 you saw this better improvement accelerating in June. And the month of July was even better, only a decline of 18% towards previous year. So yes, we saw also the same development.

[0:41:01] Christoph Laskawi

Thank you. That's it from my side.

[0:41:04] Helmut Merch

Welcome.

[0:41:06] Operator

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

[0:41:10] Sebastian Growe

Yes, good afternoon. Thanks for taking my questions, Mr. Merch. The first one is on Automotive and back to the strategic options. Can you just share with us any potential timeline, if any?

The second one is a bit related to what Christoph asked before on the outlook for Automotive and the trading update, the 15% decline. So the latest, I think, registration figures and sales figures would rather see, I think, a – I wouldn't call it outright positive, but at least not with a big minus in front, current trends. So the question is simply, why it's still 15% down? Is it customer mix related or anything we should have in mind here?

And then for Defence, the question is a bit more on the further trajectory, i.e., beyond fiscal 2020. I know it's not easy for you to comment on it, but it's more really to look at the whole thing from a higher level. I think when taking into consideration the pipeline comments you made on what is happening, especially I think in Hungary and the potentially bigger order volume that you – what might have anticipated before the good things eventually in the Czech Republic, UK, etc. The question simply, what volume you can deal with in the current status quo with the Australia ramp-up, etc. you feel actually quite comfortable to also go towards EUR5b at a certain point in time?

And then around the margins trajectory for Defence, we are seeing now around 10%. And I think the indications you gave potentially could be a bit better, are quite helpful, I guess, in this context. Can you also talk around the backlog quality and how you think we should think about the margin going forward when looking more two, three years out from here? Because I think it has been simply fantastic operating leverage story, better mix story, etc. So is there any striking reason why this cannot continue?

And if I then may really have the very last question, it's around free cash flow and the net debt. You called it normal seasonality. What happened in H1? Quite frankly, you have seen an enormous working capital build-up of more than EUR400m despite sales being down EUR200m. You have been talking about security buffers in Auto. So how should we think about the especially working capital trajectory going into the second half? Thank you.

[0:43:31] Helmut Merch

Yes. So our focus is clearly to generate free cash flow. But I think we are actually acting in extraordinary times and the negative free cash flow in Q2 is clearly not unexpected due to the high loss in Automotive.

So still our target is to operate on a free cash flow situation end of this year. But due to the volatility of prepayments in Defence, it is hard to predict. We have a clear eye on CapEx in Auto and on working capital and therefore we think that the cash flow situation in H2 will and should be better than H1. But actually, I will give not a clear guidance here. I think we have to wait for the Q3 call.

The questions around our Defence perspective, I think actually we have a very strong backlog and I tried to explain that we have a pro forma backlog within our frame agreement of further EUR3b. So this gives us good confidence for future growth with the addition of the potential of the East-European customer and also Czech Republic and potentially the Challenger upgrade in UK, and hopefully also a good situation in Australia. But the latter will not occur before 2022, and also having in mind that it’s at the horizon a second lot of Puma. There is a clear task and a clear wish to build up further the order backlog to underline our growth perspective.

Regarding EBIT margin, yes, and I want to stress once more the difference between the three divisions. We have a double digit margin business in Weapons & Ammunition which will continue on this high level of profitability between 12% to 14%. We have reached so far our last strategic target in Electronic Solutions and Vehicle Systems of 8% to 9% of operational EBIT margin, and I will not exclude that we would be able to look for 10% in both divisions. But this could be also a temporary situation. It highly depends on the product mix and mix of different programmes. So now actually for 2020 we want to reach clearly the 10% and further guidance we will give you in March 2021.

Then on Q3, Automotive forecast, here we are more or less in line with the latest IHS forecast for the global market excluding China. And here the latest prediction is around 14%. We are actually looking for 15%. I just said that the month July saw again a better situation than June. The market is volatile and if we will come out with a better figure, then we are happy. But for the time being I think we should stay with minus 15%.

Regarding strategic options and possible timelines, I just said we will concentrate firstly on Hardparts, and here this will be more or less the business around pistons, small and large bore pistons, but we will take no action before year's end.

[0:48:06] Sebastian Growe

Okay, that is extremely helpful, thank you so much.

[0:48:09] Helmut Merch

Welcome.

[0:48:11] Operator

And the last question comes from Joseph Ayoola. Please go ahead.

[0:48:16] Joseph Ayoola

Hello, good afternoon.

[0:48:18] Helmut Merch

Good afternoon.

[0:48:16] Joseph Ayoola

Maybe just a couple of questions from me. The first I guess is following up on free cash flow. It would be helpful if you could share your expectations around potential prepayments on the big ticket item you were talking about the second half in Defence.

Also just staying on Defence as well, Weapon and Ammunition showed general strong growth in the quarter. I was hoping if you could share some detail behind what drove that, and particularly around if there's been any benefit from export bans and relief around that.

Then finally, just coming back to restructuring in Autos. Part of the restructuring Mechatronics was around realigning the business through reduced dependency on combustion engines and entering new markets. Any color you could give that would be helpful too. Thank you.

[0:49:10] Helmut Merch

Okay. Coming to the second question regarding ammunition business. Here, yes, we saw a good growth in Q2, but as you know, the strongest quarter is always in Q4 and this will be the same pattern this year. Here we saw an earlier shipment in Q2, which was originally planned in Q3. That was one major explanation. And the EBIT development is clearly driven by the ammo business. For the full year we expect a growth in the pure ammo business of over 20% and therefore we have here a clear driver for the development, especially in H2.

Regarding free cash flow, I think I can only repeat what I just said. We are highly dependent on prepayments in Defence and I'm very much confident that we are able to be in a better shape in H2 regarding the order development. Here we saw the biggest loss in Q2, and Q3 will be clearly better. In case the forecast of IHS will turn into the right direction, then also Q4 should be better regarding volumes compared to Q3. And this expected recovery in H2 also should help the cash flow development.

Please repeat your question regarding restructuring in Mechatronics. I lost a little bit the content.

[0:51:17] Joseph Ayoola

Yes. I was just pointing out that you mentioned there was some realignment of the business to reduce dependency on the combustion engine and also entering new markets.

[0:51:28] Helmut Merch

Yes. I think we have a great technological base in Mechatronics. We have a high volume, for instance, in the pump business, or we are producing a lot of actuators and electrical motors. And we could imagine that there are a lot of additional applications outside the Automotive and this could be one direction which we are going to follow in the next 24 months. But I think all these projects are still in the early stage and if we are going to launch something significant then we are immediately informing the capital market.

[0:52:18] Joseph Ayoola

Okay. That's clear, thank you.

[0:52:21] Helmut Merch

Okay. Fine.

[0:52:23] Operator

Okay, at the moment we have no further questions. If you would like to state another question, please press 9 and the star key on your telephone again. I will just wait a couple more seconds. Okay, so there are no further questions. Let me hand back over to your host, Mr. Merch.

[0:52:52] Helmut Merch

Yes. Then I thank you all in participating in our Q2 call, and I hope we can hear us again in our Q3 call early November, and till then please stay healthy. Bye-bye, and have a good day.