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Rheinmetall AG Conference Call

[0:00:01] Operator

Good afternoon, ladies and gentlemen, and welcome to the Rheinmetall AG conference call regarding the second quarter results 2022. 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 CEO Armin Papperger.

[0:00:24] Armin Papperger

Thank you very much for your kind introduction, and a warm welcome to all participants to Rheinmetall's Q2 2022 earnings call. It is my pleasure to walk you through this presentation together with my colleague Helmut Merch. But before I present the highlights of the second quarter, I would kindly ask you to take note of our legal disclaimer on the following page.

If you go now to page three, the second quarter in line with expectations. So the group sales growth of 7.1% to EUR1.408m. Operating profit rose by EUR7m to EUR114m. We have a stable operating margin of 8.1%. Order intake is fine with EUR1.427b, including the strong growth of our civilian business of 34%, we are on a good track. OFCF marked by working capital build up. That is important for us at the moment that we are able in the second half to make our sales. I think we have a very, very successful Eurosatory participation, especially with our main battle tank, the Panther. I will give more details later about that. And the full-year guidance 2022 is refined.

If you go to the next page, you see the picture of the KF51, our Panther that we presented the first time at the Eurosatory. Some information for you about that: what is the reason that Rheinmetall made it? First of all, it's a very long time that we need for the main ground combat system, and if the main ground combat system will be implemented between '35 to '40 or maybe later than '40, we think there is an in-between period where Europe needs more new main battle tanks.

So we created a main battle tank which is a very high effective weapon, so we integrated the 130mm Future Gun System, which is at the moment only available for Rheinmetall. We have an excellent protection, so this is side protection and this is top attack protection, and we have really a survival concept which implements 360 degrees active, could be reactive and also passive protection. It is fully digitized, and the digitization helps us a lot for the connectivity between tank to tank, between main battle tank to other tanks and also between the soldiers and the tank, which at the moment brings our soldiers home safely, which is the most important thing.

So what is the potential over the next years of this main battle tank? And I think we could be successful in some countries, and we offer this to all users in Europe at the moment two weeks ago, and there is a potential of minimum some 100, but maybe over the next ten years a potential of about 1,000 main battle tanks. This is the need where we want to go into competition with our other competitors.

If you go now to the next page, you see that Rheinmetall is in the sweet spot, and for me the long-term story is 100% active of market growth within the NATO. And if we go now to the left side, we see that the shifts in the defense budget from 2021 to 2030. Defense budget share of GDP will grow from 1.6% to 2.2%. This is at the moment the information we've got from the European Union 27 countries. The investment share of defense budgets will grow from 20% to 30%, and the share of land systems in investment volume will also grow from 25% to 30%.

What does it mean for the different countries? And here you see that Rheinmetall is really positioned in the sweet spot of growth. Digitization is one growth driver, and on the other side also land systems because there is a huge need in all the countries on the land system side. It’s always – and then this is the problem that usually the governments are not as fast as expected. But Germany will spend on the land system side more than 20% in the CAGR of 2021 to 2030.

The core markets where Rheinmetall is – this is Italy, Hungary, UK and Australia – we see the growth rate of about 10%, and the rest of Europe also about 10%. So in total over the next years, our expectation is that the growth rate is intact, and at the moment, as you know, it's a delay and this is what you see on the next page.

This is also a decision which is very clearly also coming from the office of the chancellor that there is a clear commitment of the base budget, which is about EUR50/51b, and slowly we will grow up. The first expectation was that it will happen over the first four years, EUR25b on top, but with the delay of the contracts and most of the big contracts at the moment, there are some in negotiations but not signed, and later I tell you where we are. We will have a backend loaded order intake and sales and after the special fund, and this is a positive signal, the government says they want to do everything that they will stabilize then this EUR70b to EUR80b for defense because otherwise it would be a small period of four, five, six years where we can fulfill the 2% percent, and the NATO 2% goal will be reached which is a must. This is what the government says at the moment, also long term, to make the Bundeswehr in, to bring them into a position that they are able to fill all the NATO targets.

If you have a look to the next page, page seven, you see that we look to the EUR100b special fund, and there is first of all apparel and personal equipment. Rheinmetall is very strong in this area because we produce from helmets to underwear, everything which is going there. The decision of headsets and also of helmets is done, and the Gladius Soldier System is the big pack of the EUR2b so that we're nearly the whole EUR2bn will come to the Rheinmetall family.

The second point is the army. On the army side there is EUR17bn, and it is EUR8bn to EUR9bn, around that, where we go into negotiations with Rheinmetall. What is the situation that we have? The upgrade of the first lot of Puma, the order intake will come in this year. The Puma second lot is also planned in this year. On the next page you will see then exactly when our expectation is that order intake will take place.

Schwerer Waffenträger, where it's also verbally a very clear decision that the Schwerer Waffenträger will be end of this year, and the nationalization of BV 206 where Rheinmetall is the partner for Germanization for Hägglunds. The new airborne vehicle system family and the successor for 6x6 Fox and also Boxer 8x8. The successor for Fox could be Fox 2 or a cooperation that we do with a Finnish company, but Rheinmetall will be the producer because we have the capacity to produce it, and this is also very clearly discussed with our government.

The digitization land is where we see especially D-LBO. The start will be next year and it will be over the next years up to 2028. There are between 25 and 30,000 vehicles where we may have to make the digitization, and we see a potential of EUR6bn for Rheinmetall in this area. And as summary navy and airborne, these are countermeasure systems, ammunition, protection systems, weaponry, and also the SHORAD system, which is part of the air force, we see a potential of EUR2bn.

The defense base budget, this is what we call Einzelplan 14. The ammo is inside and the trucks, because of the special funds, there is now space in the EPL 14. And we are in negotiation (for ammo and trucks) and the start will be in 2023, and this is because it's not part of the EUR100b special funds only possible in 2023 and not in this year. This is by law in Germany. We have over ten years. The government will give us over ten years contracts, minimum EUR500m up to maximum EUR700m per year, so this is a EUR5bn to EUR7bn frame contract. EUR5bn will be in the frame contract, and up to EUR700m will be a part to use the budget.

Usually end of the year, the government has a budget and they cannot spend all the money, and we have to prepare ourselves to help the government that they spend the money with ammunition on one side. And on the truck side there is also framework contract in planning for the next ten years, which a minimum of EUR500m up to EUR800m per year. And this is now, if you calculate everything together, this opportunity – we spoke about potentials, but potential is always coming nearer and nearer to that what is coming really out of the potential. And if you calculate everything in this area you see that the potential is going to real contracts where we see now much better that it is more than EUR30bn, up to EUR35bn.

So in the next page, eight, we see the current timeline for potential order intakes. And last time we told you at the moment there is a parliamentary summer break. It's until September 5th. Then the first meetings that we have then in the parliament, there is a discussion that Puma second lot and upgrade option will have to come in, because Ministry of Defense wants to sign the contract as soon as possible.

This is an opportunity now that we have, and I see it very clear because it's very clear, also straightforward order from the Ministry of Defense of EUR1.5bn. The IdZ frame contract has this volume of EUR1.5bn. This is out of the EUR2bn that you have seen before, and the Wechsellader will be – this is the trucks, EUR100m, because the frame contract is coming then in the first half of 2023. Between 2022 and '23, hopefully also end of this year, the government wants to have it end of the year, is Schwerer Waffenträger between EUR800m and EUR1bn, depending exactly what they want to have into the vehicles. And the other point is that the discussion about Caracal,this is the 4x4 vehicle where the first lot will be EUR300m, and this will be also end of the year, beginning of next year.

In 2023, then the two frame contracts are for us the major tasks to get the ammo contract and the truck contract, and again we tell you, and this is a point which is very important for us. We tell you the opportunity. We tell you the discussions which we have at the moment, but at the end of the day for sure it is then the point which decisions the government's makes. But I hope it is fine that we give you the transparency about the discussion that we have with the governments, as otherwise it would be impossible to give you a view into the next 12 or 24 months.

In the second half of 2023, our expectation is that C-ATV, the 600 vehicles, the Germanization contract will come also the CAVS program. And the reason that they have to come in this area is that there must be a success in the (current) legislation period from this government, and the same happens with Boxer where there is a minimum need from Germany of more than 400 vehicles on the 8x8 vehicles.

So coming now to the Lynx and to the Lynx story. We are very clearly not happy about the decision of the Slovaks and also of the Czech Republic, and what is the reason in the background about that, it was very clear and I've got the indicationalso from the German government because the Slovakians and especially the Czech government spoke with them. It's a political decision because, as you know, the Czechs want to step in Ringtausch area with the Leopard, and they want to step out of the Gripen program so that they want to make a compensation, a political compensation, with the Swedish side.

Not good for us. Not happy, but again we give you an indication and an overview about the potential of these different things. I always told that if we cannot win 100% of the potential, but I really thought that we are able to win one of the two countries is able to win but both countries decided politically.

What is now, if you see on page number nine, the next decision? The next decision will be Australia. If you ask me and said, "What is your gut feeling?" I also have a good gut feeling in Australia because the tests are very good in Australia. If you ask me, "Is it 100% that we win the deal?" I can tell you the answer in September because then we have the decision. You never know what political decisions are coming up, but my gut feeling is a good one.

The tender expected in Italy is now in 2023, and the Greek tender will also be in 2023. The vehicles there, the first bunch of vehicles that they need in Italy, is minimum 200 and the same is in Greece. And you know all the background. There are no news about the US Bradley replacement. I must not repeat that.

So what happens now and what is the current situation on the ring swap agreements? And here we are in daily negotiation with the German government. The office of the chancellor and the Ministry of Defense want to make it happen. At the moment there are negotiations with the Czech Republic, with the Slovaks, also with Slovenia and with Greece. And as we know, they want to deliver and they delivered, some of them delivered, their old Soviet Union vehicles to the Ukraine, and they are looking to get Leopards and also the Marder.

The situation that we have at the moment is the Czech Republic is looking for Leopard 2s. The potential that we see or the negotiation with the contract are on a level between EUR150 and EUR200m in the first shot. The same is with Slovaks. It's also in this area, and the Greek side – Greece is looking at the moment for 30 Marders, which would be without ammunition, a level between EUR30m and EUR40m, and in total they want to have 100 Marders by the end of the year. In September, 30 Marders will be ready and end of the year about 60 Marders will be ready. So it could be a good order intake. But also the bunch of sales you will see in 2023 and 2022.

So the potential of direct deliveries to Ukraine are also there, but there is no decision and at the moment the decision of the government is to give Marders not directly but indirectly via ring swap to the Ukraine. But self-propelling howitzers, you read this in the newspapers. There is a discussion. There is still no contract, and the new vehicles where our partner in Bavaria is holding the main contract, but the amount of Rheinmetall will be between 50 and 60% what we produce because we are the producer of the chassis, components of the turret and for sure the weapon which is the main element also in the self-propelling Haubitzer.

So what does it mean? And you see that now in page number no. 11? And there is now a point where we see first of all some three months ago there was a discussion that it would be possible to bring also the frame contracts of ammunition inside this year. This was not possible because we brought it out or the German government brought it out of the EUR100b budget. So because it is in the EPL 14 now, we have a reduction on the order intake from EUR13bn to EUR15bn to EUR10bn to EUR12bn. The other point is that one of the two contracts we expected into our order intake, so there was a reduction of about also EUR1bn in the order intake side, so now the guidance in Q2 is between EUR10bn and EUR12bn.

We stay in 2023 on an estimation of EUR14bn to EUR15bn, and the reason is that we now expect that the ammo and the truck contract to be included in these agreements, and I think it's a very good figure if we are able to reach this value. By the way, 10 to 12bn is also a very good figure.

So because of the delays, and you see this now in the next page, in the page 12. As you see, in 2021, we had this EUR3.773m. We stay on EUR4.5bn to EUR4.6bn, so a plus of around 20% on the defence side that we guided in 2022, and because of some delays we are a little bit careful about that and this is the reason that in 2023 for the estimation we step from EUR5.5bn to EUR6bn to around EUR5.5bn.

The reason is very clear. This is because of the delays of contract. If there is a delay of three months in order intake, especially from the German side because the government needs some time to make decisions about that, it is hard for us to stay at the same level because you also have delays then also in the sales side. It does not mean that risk is growing much because at the end of the day if we have the contract, it's fine, but we have to bring the contract in and then that is the reason that we stepped on the Eur5.5bn.

Page 13 shows now the downward revision driven by the semiconductor shortages, also by supply chain disruptions. We know all about the Zero COVID strategy in China and the China harbor blockages, and that means that the expectations at the beginning of the year is that growth rate of the civilian products and especially of the LV production growth will slow down, and you see that in May. We saw a growth of 4.4% and 4.7%, which IHS told us for August.

The growth fully depends now on strong second half year. The expectation is now that not a full lockdown comes again on the Chinese side because then we would have also a negative hit and an additional negative demand effect of the Chinese lockdown. The Sensors and Actuators sales are expected to improve only slightly compared to 2021 and less dynamic to then what we expected earlier. Materials and Trade is in good shape, and expecting to win this nomination letters will drive our book to business to around EUR3bn in our civilian business.

What does it mean now for our guidance? The organic self-growth will stay about around 15%, and the operating margin will be more than 11%. So in a nutshell, it will be the best year in the history of Rheinmetall. We have some delays in the order intakes, not because we are not able to sign the contracts. It's because we have longer negotiations with the German customer to bring this bunch of contracts, and it's really a bunch of contracts and the contract that the German government has to handle. RMMV is working very hard on that, but there are delays. So I want to hand over now to my colleague Helmut, and he takes care about the financial of 2022.

Helmut Merch

Thank you Armin.

I will start with the presentation of the key financial data on page no. 16. Please be reminded that all figures apply to the continued business activities unless stated otherwise.

Group sales as already mentioned of roughly EUR1.4bn grew by 7.1% including some positive FX and M&A effect. In the current inflationary environment, we were able to maintain our strong year's margin level of 8.1% and lift operating profits to EUR114m.

The special items mostly relate to the mark to market valuation of our liquidity reserve due to the current market environment. Reported earnings per share from continuing operations declined from EUR1.45 to EUR1.21 or roughly 17% in the second quarter of 2022 compared to the prior-year period. Please continue on page no. 17.

Operating free cash flow from continuing operations declined year-on-year by roughly minus EUR200m to minus EUR179m in the second quarter of the running year. This year's development resulted mainly from the necessary build up of working capital. And as we already told you we are continuing to build up stock in order to relieve our supply chains and to secure our future growth potentials.

Additionally, operating payments received from major projects in Q2 were more or less on level with the prior year but lower than we originally expected for the Q2. Please turn now to page no. 18.

Let’s have a brief look at our strong balance sheet. The equity ratio further improved to now 35.1% as of last of June. Net financial debt from continuing operations was minus EUR888m at the end of the second quarter, compared to positive liquidity of EUR118m at the end of 2021. The change is mainly related to the above mentioned working capital build up, the cash out for M&A transactions and higher dividends, which we have paid in May.

One word on our pension obligations: we are continuing to see the positive effects from the discount rate increase in Germany and Switzerland, which were the drivers behind the reduction of the pension obligation to EUR527m. We reported a cash position of EUR236m at the end of the second quarter and additional securities held for trade with a value of EUR135m.

Moving on to the divisional performance on page no. 19. Group sales rose as already said on a reported basis of 7.1%. We saw again a strong performance of our defense divisions. Division Weapon and Ammunition reached the best Q2 operating result of all times. Electronic Solutions saw a remarkable sales growth of almost 25% and grew absolute operating result by almost 15% to EUR21m. Vehicle systems sales were slightly below the previous year, but profitability achieved 10.2% in the second quarter. Sensors and Actuators as well as Materials and Trade were also able to show growth but the volatile market conditions already left their mark especially in the division Sensors and Actuators. Overall sales growth was below our expectations which we expressed in our Trading update during our Q1 call. Materials and Trade continues to see a healthy sales recovery of almost 14% and an operating result before the negative at equity effects, of roughly EUR15m. At equity burdened with minus EUR3.3m because of the lockdown effects in China during May and June.

The operating result of EUR114m the group grew 6.8% compared to last year. The margin level remained stable at 8.1% year-on-year showing our ability to manage rising input cost. All divisions except Electronic Solutions showed a negative operating free cash flow, mainly driven by working capital build up and lower prepayments.

The increase of the consolidation line in Q2 has two main drivers: 1. a redesign of our cost allocation process with the goal to increase cost transparency leaves more cost on corporate level. And 2. We had higher cost on corporate level, especially for marketing and R&D.

On page no. 20 you see the order intake and order backlog profile for the divisions Weapon and Ammunition, Electronic Solutions and Vehicle Systems. The second quarter 2022 compares to a very strong previous year's Q2 with big orders including the Challenger upgrade for UK, the recovery vehicles and Puma upgrade contracts for Germany. Leaving the absence of big order aside, the second quarter still showed a good order intake of above EUR800m. The positive book to bill ratio for the combined divisions now lifted the backlog to a new record level of more than EUR15bn. And as Armin already described, we are expecting more ahead of us. Please turn to page no. 21.

The positive development of the booked business in our civilian divisions continued in the second quarter. We reported a growth of more than 30% to EUR603m. Q2 experienced high interest for conventional ICE as well as hybrid technology in the market for light vehicles and trucks. Year to date, we have already generated new business of EUR1,835m. And we are expecting to win nomination letters that will drive our booked business to around EUR3bn basically on the same level as last year.

Let us now move to page no. 22 and the current situation of our Chinese market and our local activities. The massive outbreak of corona cases in China resulted in strict lockdown measures provoked by the Zero-COVID policy from the Chinese government. From mid-March to early June, Shanghai area and our JVs with production sites in and around Shanghai were in a hard lockdown. So two of the three months of the second quarter were heavily impacted.

On the positive side we were able to receive the hard to get permission from the authorities for a "closed loop operation." As a result, our sales during these months were not zero, but very, very low. Employees continued to be paid, albeit at a discount, and other fixed costs continued to be incurred. This resulted in losses, particularly in April and May. In June, production and the market ramped up again strongly. The outlook for the next few months until the end of the year is also positive, so it will be possible that part of the existing gap can be closed in the second half. However, uncertainties of a renewed lockdown remain and no one can reliably predict that. Please move on to page no. 23.

Energy cost account for less than 1% of our total cost last year, but obviously they are essential to operate the business. While our full year cost development is already well protected, we have started earlier this year to look or to switch to alternative energy sources.

And as already indicated, we have started earlier in the year to build up safety stock. In order to further stabilize our supply chains, we are now qualifying more and more sub-suppliers. From a price perspective, Q2 saw probably the peak for most key raw materials, but prices currently remain more or less on high levels.

Interest in Rheinmetall group continues to be high. This helps us to fill our vacancies and to grow our work force. In the first half of 2022 we have hired around 900 additional full time equivalents, most of them in the fields engineering and information technology. The new approach of our centralized recruitment organization now pays off.

This closes my remarks. Thank you for your attention and I hand back to the operator to start our Q&A session.

[0:36:21] Operator

Yes, ladies and gentlemen, if you would like to ask a question, please press 9 star on your telephone keypad. Please press 9 star on your telephone keypad, if you like to ask a question. And the first question comes from Sven Weier. Your line is open.

[0:36:49] Sven Weier

Yes, hello, good afternoon. Thanks for taking my questions. The first one is on the order intake guidance you have updatedand I was just curious first of all on the 2023 international order intake. If you just taking out the Czech contract there or is there anything else? And I was wondering, how you dealt with the potential Howitzer contract in Ukraine, if that's inside the bar or how should we feel about that? That's the first one, thank you.

[0:37:23] Armin Papperger

Thank you, Mr. Weier. So yes, we took the Czech out and one of them, as I said, Czech orSlovak we expected to win. We took this out. This was an area, as you said, what we calculated between EUR1.5bn and EUR1.7bn.

The other point is that from the Ukrainian side we are at the beginning. We have the first small contracts from Ukraine directly. The first contract that we signed was an ammunition contract. We are looking now for more contracts, and we discuss daily about contracts like also air defense opportunities, that we have other bigger ammunition opportunities. This is not included inthese figures, because it’s too early for us at the moment to say okay, if it works or if it does not work. And we really do not know what happens in the Ukraine over the next months during the war.

[0:38:28] Sven Weier

And so the Howitzer one is also not in there?

[0:38:30] Armin Papperger

No.

[0:38:33] Sven Weier

Okay, it makes sense. Then on the – but you assume on German ammunition, I mean, I get it in terms of that is now done annually.

[0:38:41] Armin Papperger

Yes.

[0:38:42] Sven Weier

But given how depleted the German ammo stocks are, wouldn't that actually speak more in favor of the front loading of the orders, or -- ? Because EUR500m, EUR600m still seems a little bit too little to get where they need to be.

[0:38:56] Armin Papperger

Yes. This is what I told the government also, but it's a decision from the governmental side. You know the story and the chart gave us a very clear overview that there is a need of EUR30b for the stock. But at the moment the budget in EPL 14 is – this, what I told you, yes? This, in total there will be per year and this is what I told you for Rheinmetall, but in total it will be EUR1bn maximum, EUR1.5bn out of EPL 14. And I said for the Rheinmetall side, this is what I – the information we gave you, between the EUR500m and EUR700m maybe it is sometimes EUR800m.

If it is enough, everyone knows it is not, but the problem that we see, and this is the discussion that is very important also for me, we only can give you the information that we have today. If the government, and you know sometimes the governments are changing also their directions, yes? Then we have to give you a better information in some weeks later. We gave you the first indication of the start of the war five months ago. I think we were very transparent that we have a look into the glass ball and we see the opportunities and the potential which is coming up.

Now we are nearer to the contract, and nearer to the contract you always know that if I feel – if we show you 100% of the potential, that's not 100% at the end of the day will come out.

So therefore, I see it very clear now what happens over the next month, and this is what we told you with Puma, NRM Puma and with the other vehicle programs which are coming up. A clear decision from the government was not to take the ammunition into the EUR100bn programme but to make a reservation of money in EPL 14. That came out, that is the situation at the moment of discussion. I cannot say more.

[0:41:15] Sven Weier

Yes, that's understood. The second question I had was on the longer term growth expectations. You lined out on slide 4 with the over 20% CAGR in Germany and so forth. If I do the maths there, then I would arrive at around defence there that may be EUR13bn by 2030. So it's kind of in the mid-twenties, still a sales potential of let's say EUR9bn that you see for the defence. Or has that also changed now?

[0:41:46] Armin Papperger

No, my expectation is on that. It's still in this area, because I think there will come up because the crisis is not stopped. Even if in some months there is a more peaceful situation between Russia and Ukraine, I believe that we still have especially in the NATO countries and the European countries a huge need, a huge need of everything that we have, especially also on the land forces side. So therefore, I believe still in that what we discussed before.

[0:42:22] Sven Weier

Fair enough. The last question for now is just on when I think about the margin implications of your guidance for 2022 for the Defence business, it seems to me that the Defence margin improves by around 100 basis points this year. So another good improvement. Is that it for now? Or do you still see there's further upside then also beyond 2022?

[0:42:49] Armin Papperger

I think there is a potential, and the reason is also the leverage that we have internally. So where is it exactly depends for sure a little bit also, and you know that, about the contracts that we are signing. At the moment the contracts we sign are really good. My expectation is, and this is also what I told you long-term, if we grow in 2025 in the area that we discussed before, my expectation, and this is what I very clearly give into the division, that in total the Defence profitability should go nearly 15%.

[0:43:33] Sven Weier

Okay. Good to hear. Thank you very much, Mr Papperger.

[0:43:38] Armin Papperger

It's a pleasure.

[0:43:41] Operator

The next question comes from Sebastian Growe. Your line is open.

[0:43:47] Sebastian Growe

Yes, good afternoon. Hi, Mr. Papperger and Mr. Merch. Three questions. The first one is on the pipeline. You discussed before the main ground combat system but also the need for, I would say, a bridge solution with the Panther and especially that is for Europe. So I would be interested in your thoughts around the respective target markets in particular and how you view yourselves positioning compared to competition. The background of the question is the unfortunate outcome regarding the Lynx. So if we could start there, please?

[0:44:20] Armin Papperger

Yes. So first of all, we are absolutely convinced that the period for main battle tanks will be also over the next 15 to 20 years where we have to deliver. So that is from internally strategic thinking. It is too late for main ground combat systems because at the moment we really think that this more – this series production start is more to 2040 than to 2035.

The second point is what is really the outcome of all the discussions between the French and the German government. We don't know that. So that was the reason that we made a clear decision to say, okay, we invest in this because there is a need. And that there is a need of decision you see, and what happened in Poland. That's because Poland is now going to – so let me say, it seems to be, because it's not a final decision, what I know. But they look to the Koreans now, what is going forward, and it should not happen in Europe that we are not able to deliver on the European side also with our equipment.

So therefore I think, first of all, there is a need. And the second point, there is a huge possibility also to have a version which is a very modern version with minimum 10 extra items that at the moment our Leopard, where we also have an integral part inside, it's not able to offer. So that was the reason that we wanted to implement this Panther.

I can only tell you at the moment the feedback that I get from the market side. The feedback from the market side is a very positive one. They said, okay, wow, it's great to have all these technologies inside. And the other thing is about the pricing, and they said on the pricing side, this Panther with all the features that we have should not be more expensive than at the moment the Leopard 2A7. It should have a lower price than that.

How is it possible? It is possible with other technologies, with other sub-deliverers, where we have insight there for the main components. We are really able to reduce the costs a lot.

So now coming to the competition side, there is competition, as you know. There is a competition from South Korea. They act via price. The price is much lower than the Leopard. If you go to Leopard 2A7 at the moment there is a range between EUR18m and EUR20m per piece, which is a high price in comparison to the Korean side. So this is from our strategic side point number one. We say, okay, we have to lower the prices, and this is what we want.

Is there a point that we have to reach exactly the price of the Koreans'? No. We can be a little bit higher, but not as much as it is at the moment.

Another point is for sure in Germany that we have, like the Puma and the Lynx on the infantry side, we have two versions now. We have now the Leopard and we have now the Panther. There is also an internal competition. But it's not our task to win 100% of the contracts which are there. I think that over the next 20 years there is a possibility, because we have, as you know, 8000 main battle tanks, and there is a possibility that a minimum 1000 main battle tanks must be replaced. But I think it's more than that. If we are able to win only 50% of these opportunities, it's a huge opportunity and a huge order intake for us.

[0:48:39] Sebastian Growe

Okay, thank you for theaddtional color. Really, thank you for that. And just related to it, that also then was the sort of volume that is needed to be ultimately price competitive or a bit only more expensive than the Korean product? I.e. that you need to have that about 500 units? Or how shall I think about that in order to just make the cut?

[0:49:00] Armin Papperger

Yes, first of all, for sure you need some figures. But it is not that we need these 500 units. We calculated that over a long-term period that we are able, as I told you before, if we win 50%, so it's 500 to 1000, and then the price is more than good, that we calculate at the moment, or the price that we gave to our customers. So we are happy with that.

If we would not be successful and only can sell 20 or 30, then for sure the payback is not the best, but this is the business model that you always have, and this is what you have to do as an entrepreneur, to take also the risk, to go into risk. But everything what we at the moment invested and we paid, there is most then really coming. We paid and it we not activated most of the things. So this is also very important for your understanding.

[0:50:14] Sebastian Growe

Okay. And related to it, sorry, because it just comes to my mind, after you had those, not won contract in the Czech Republic and Slovakia. Is there sort of negative spillover in fact on the overall profitability level and your planning that you had in mind before when it comes to especially that product category? Or how shall I think about that?

[0:50:34] Armin Papperger

No. I do not see this. For us really important is the Australian contract now. And as I told you before, nobody knows exactly what happens. If you ask me, I have a good gut feeling. I know the feedback that technically we are really good, on a good way. Australia, it’s a very, very positive game changer in everything if we win the contract, what I believe in. But I cannot say it will happen 100%, so I can tell it to you in September/October, because then they want to make the decision.

So I spoke with the new Minister of Defence. I’ve got a good impression about everything, but he can tell you for sure not -- you are the winner or you are not the winner. So I cannot give it to you now.

But Australia is important for us. It’s much more important than the situation that we have with the Slovaks, because first of all, it’s a bigger contract. The second point is the investment in Australia is 100% done. In Slovakia and the Czech Republic we have to make this investment. So this is on one side a good thing for Europe. On the other side it would be also for sure some burden, because we have to produce something in Czech or in Slovakia if we would do it.

We would be happy to do it, because it was part of our business plan, but you cannot win all the contracts. This is, by the way, over the last six, seven years, I think, the first contract that we lost. If you remember about that, what we told you on the potential.

[0:52:20] Sebastian Growe

It's quite a home run, indeed, over the last many years. Okay, switching gears and quickly on the guidance, if I may. The first one is on EBIT and it goes more to Mr. Merch. I was wondering if you could give us some better sense with regard to the profitability between both operations or more the Defence part and the civil business. I'm asking that question because we have seen the higher costs on the consolidation line that you also commented on. So I would be just interested if you could give us a bit of a yardstick on how we should eventually think of the sort of embedded costs in the consolidation line which come along with the greater cooperation between segments within Defense. I hope that is understandable, what I'm after?

[0:53:02] Helmut Merch

Sure, sure. So the question refers also to the question of Mr. Weier, how do we see this year's performance? Last year, if you look back, we had an operating margin in the Defence of slightly above 12%. This year we expect the Defense division a margin of roughly 100 basis points more.

Last year in the civilian business, we generated operating margins of roughly 6.5%. We expect an operating margin for the civilian business in the range of 6.5% up till 7%. So the push of operating margin of the Group is clearly Defence. But you have to see the challenging environment of the automotive market. Here we have still the major part of the civilian business. Therefore if we look to the operating margin in Q1 and Q2, especially in bigger parts Sensors and Actuators, they made a quite good development. But as we see it, there are uncertainties ahead of us, but this is the answer to the first half of your question.

Regarding consolidation line, yes, if you look to the order backlog, the major part of the order backlog in the Defence division belongs to vehicle systems, and vehicle systems, as explained by Amin is the driver for the upcoming growth. On our vehicles we are able to place many parts of electronic solutions. With armored vehicles we have the gun and also the ammunition. The driver will be vehicle systems and therefore the combined contract or the sub-contract which will be given by Vehicle Systems to Electronic Solutions and to Weapons and Ammunition will increase. Therefore the line item consolidation concerning sales and an EBIT definitely will grow.

[0:55:45] Sebastian Growe

Okay, understood. I can't really like the margins probably rather than 150+, a bit up, not only the 100, or that you just make up for the higher consolidation line expenses.

Well, moving on, the last one from me, the cash flow. You did reiterate the 3% to 5% target range for fiscal 2022, so that implies EUR200m to EUR300m plus for the free cash flow. And we had a cash burn of 850 in the first half. So if you could give us a bit of a framework around what is coming from now on, an unwind of working capital, what is related to prepayments, that would be super-helpful.

[0:56:19] Helmut Merch

Yes. By far the larger part will be dedicated to the unwind of the working capital, because here we are in pre-financing of roughly EUR300m of orders which we have not signed. This will be heavily dedicated to the decisions which will be made after the parliamentary pause. So there will be some contracts, especially around Wechsellader and also the IdZ which will be signed. And here we promised the customer to pre-finance in order to make respective deliveries.

But on the other hand, looking to the expected order intake pipeline for the second half, which is between EUR7bn to EUR8bn or EUR9bn, we also expect some prepayments. So there will be a mixture. But on the other hand, I already told the major part of this will be by reducing working capital and collecting for receivables. Thank you.

[0:57:45] Sebastian Growe

Okay. Thank you very much for that and I go back in line. Thank you.

[0:57:49] Helmut Merch

Okay.

[0:57:51] Operator

The next question comes from Sash Tusa. Your line is open.

[0:57:57] Sash Tusa

Thank you very much indeed. Good afternoon. I've got a couple of questions. The first are essentially financial. I just wanted to confirm my understanding of your last comment, that we should probably be modelling the eliminations number in operating earnings as around EUR100m, which is the annualized rate from Q2, rather than the original, the traditional EUR40m. So it seems to me that that's gone up very, very high indeed.

[0:58:30] Helmut Merch

EUR100m, Sash, is a little bit too much. But around EUR80m to EUR90m, this would be the right direction.

[0:58:40] Sash Tusa

Okay. That's great, thank you very much indeed. Then the next question, the tax rate clearly varies by quarter, but seems to be very high in the second quarter, about 31%. Is your tax rate going up above 25% over the next few years? Or would you expect it to come back again in the next – in the second half?

[0:59:06] Helmut Merch

So the normal tax rate we have in the last couple of years is different a little bit between 26% up to 28%, and the midpoint of 27% is normally the guidance essentially we gave.

[0:59:24] Sash Tusa

Great. Thank you very much indeed. Then the final question I've got, which is clearly more of a Defense question, and it relates to Australia. But possibly also to the losses in the Czech Republic and Slovakia. There's been some concern that the LANCE turret for Boxer, which clearly has common technology with Lynx, has still got some development issues . I wonder whether you could just describe what you see as being the technology issues for the LANCE turret and for the Boxer CRV in Australia?

[1:00:06] Armin Papperger

Yes. On the LANCE turret, together with the Australian customer that, as you know, that we have this turret also on the 8x8 program. So we had to three months ago some point on the stabilization of the optics. This is done, and we had a review with the customer, so that we are on a level of 98% of all the things. So that there is absolutely no negative impact, even if our competitor is telling everyone. But if you ask the customer in Australia, there is absolutely no negative impact. Because if you start with a programme, usually you always have some negative impacts. You know that. We sort it out, we make it happen. We are able to do it internally. We don't need external guides about that, because it's our own development. And I see it under control.

[1:01:01] Sash Tusa

Great. Thank you very much indeed.

[1:01:08] Armin Papperger

Thank you.

[1:01:12] Operator

The next question comes from Christoph Laskawi. Your line is open.

[1:01:19] Christoph Laskawi

Hey, thank you for taking my questions as well. The first one would be coming back to the Lynx and essentially you're losing out in Czech and Slovakia. Could you comment, please, on the say marketing impact that has and how you evaluate that for what's upcoming, say in Greece, Italy and others? Do you think it has an important factor there? Or is it essentially not that important, because you will be showcasing the better technology?

Then you stressed that there was a political part in the decisions for those two countries. Is there a certain backing of the government in Germany that you would need to embed a pitch for the others? Or was that really specific only to those two countries?

And then you stressed that there was a political part in the decisions for those two countries. Is there a certain backing of the government in Germany that you would need to have a better pitch for the others? Or was that really specific only to those two countries?

And then another question, coming back to free cash flow and working capital. Now that you've specified in 2023 defense revenue target, is this also impacting the level of working capital that you still need to build? Should we expect this in terms of inventory build to be now essentially done? Or is there more to do in Q3? And just relating to the staff that you've hired, are you building a bit of additional capacity right now, because you will need it in one to two years? Or are you still short in staff and everyone that you take on is essentially 100% utilized right away on the engineering side? Thank you.

1:02:55 Armin Papperger

Thank you, Mr. Laskawi. So first of all, the political impact. It is very clear, if you win 100% of the contracts or of the tenders that you have, it is better than if you lose some. This is very clear. But is it a signal that you said okay, all the other governments now take care what’s going on? They always do it in the tenders and they look what is the best solution for the country. And I, but I think it is fair enough, if I can give you a feedback also from the Czech and Slovak side, that they believe that it's, the Lynx is technologically a very good vehicle. But you read it in the newspapers, and it's not my job to give the political decisions because the countries make their decisions. But if there are other some billion decisions about investments in the country, I understand that there are sometimes political decisions which are not in favor for us, but against us.

So what I did is that I spoke with the political elite in Germany, because also Germany is doing a lot of investments, especially in that countries, I think much bigger investments than Sweden or other countries are doing. But at the moment, we don't play politically this card and I asked if we cannot make a strategic dialogue between the German government and also the German defense industry about their things. They are open about that, but we have not a final decision on this. But we work on that. And the German government was before not open for that. After losing that, it is that we are open because you must know if we make also this old Ringtausch business, we give from the German taxpayers a lot of money into these countries, and then we can create also politically, a good interface that we bring also other contracts back into a good relationship between Germany and these country. It's now too late for these countries, but I think there is a learning curve inside. So, from the resources at the moment, we are on the way to bring the resources in that we need for the contracts that we have, especially where we are relatively safe to get the contract also from the German side. But we have to grow also in personnel a lot so that we’re not overpace. This is not the point and we are always able, if there is another contract that you would to lose to stop these activities. We do not overpace.

1:05:51 Helmut Merch

And Mr. Laskawi, regarding cash flow, you have asked, so the bulk of the working capital increase is for 2022. But we have already started to secure our supply chain to buy especially semiconductors for the next three to four years. And we established a taskforce and we got the first results. So this, we're also looking for the next couple of years. But as I already said the bulk of the working capital increase is for 2022. But also next year it will be decisive which kind and which volume of prepayments we get, especially for Germany. We are in a situation more or less to prefinance before we get the first milestone payment. But overall, we again confirm our strategic range in generating free cash flow of 3 to 5%. And this is also valid for next year.

1:07:11 Christoph Laskawi

Thank you very much.

1:07:14 Armin Papperger

Pleasure.

1:07:17 Operator

And the next question comes from Richard Schramm. Your line is open.

1:07:26 Richard Schramm

Good afternoon, gentlemen. I hope you can hear me. I have a question concerning Automotive. And here, I would be interested to hear what the status quo is on your divestment plans of the piston business and to going forward what measures might additionally be taken to safeguard the growth and especially margin prospects for this business as obviously, it's very tough in this environment here to push on the higher material cost to the customer. Thank you.

1:08:13 Armin Papperger

Maybe the first information we are on the way now with one partner under contract for the large bore business. Our expectation is that we can, we will have a signing in September. So, this is the first step. On the second side, we are in negotiations with our Indian friends to sell our Indian business and with Riken in Japan to find a way to divest this business. So on the small bore side we think the best chance is to sell now plant by plant because it must fit into the strategy of the buyers. And here are the negotiations but we are not so far as on the large bore side. From the cost side, Helmut.

01:09:13 Helmut Merch

Regarding margin, as you have experienced after looking to our Q1 and Q2 development in our civilian divisions, we were able to generate remarkable operating margins in a very tough environment. So for H1 we have in Sensors and Actuators 7.3% operating margin and materials and trade generated in H1 7.2. So in Q1 and Q2, we have faced, in my opinion, the toughest increase of raw material prices ever seen. We have reached now a situation where some raw material prices, for instance, aluminum came down, but the volatility in the market is still high. We saw first indication in June and July, that the market will recover to a certain extent, then immediately we will benefit from operating leverage. So therefore, we expect more or less a stable situation, possibly a little bit increase in the margin in the second half of this year. So, what we have told you in the recent calls, we are partly protected by material escalation clauses, which have a time lag of three to six months, and the other part of roughly 20% here we have a hedging algorithm for the rolling three years period. So, we are more or less fully hedged and protected for this year. There are some materials which we cannot hedge and where we have no material price escalation clauses. But here, we have seen in the last couple of months that our sales guys were able to pass through the major parts of the additional costs regarding energy or logistics. So we are able to perform in this volatile and challenging market, and if we will see, and there must be a change in the market, that isour expectations in 2023 and 2024. If the supply chain and bottleneck issues around semiconductors will be surpasssed, that there will be additional demand and our cost management so far has been excellent, especially in Sensors and Actuators. So if market will come back, growth will come back, and then we are also clearly able to go up to a margin level of 8 to 9% in Sensors and Actuators. By the way, our aftermarket is doing pretty well. We have already seen double digit operating margin in aftermarket. We have some burden in our bearings business which is performing on the low single digit level. And this we have to carefully look for. But the aftermarket is doing pretty well. So we are optimistic, especially for 2023.

01:13:05 Richard Schramm

Okay. Thank you very much. Just a quick follow-up on these divestments. You mentioned, should we be prepared to see further impairments in connection with this to reflect lower selling prices which might in the current environment be quite likely?

01:13:26 Helmut Merch

I will not exclude it for the time being but actually we have no signal. We have to look how the deal with the large bore pistons will go further. And I think we can give you an update during Q3.

01:13:47 Richard Schramm

Okay. Thank you very much.

01:13:51 Operator

And the next question comes from Christian Cohrs. Your line is open.

01:13:56 Christian Cohrs

Yes. Hello. Good afternoon. Thanks for taking my questions. They all relate actually to defense and financial. Maybe first, you mentioned the five-year plan to spend a

EUR100bn special budget. Do you think that the money can be spent? And also I mean, you are likely to be rewarded with tickets worth EUR20bn from the special budget. Do you think that this all can be executed until 2026? That's question number one. And then also a question related to cash flow. A more general question. Working capital is up sharply due to the preparation for sharp business acceleration. In the years to come, the business acceleration might be even or will most likely be even more pronounced. So are there ideas to better or to negotiate more regular milestone payments that you do not have to prefinance the business in the years to come? And lastly, Italy, you made a 49% bid for Oto Melara. Have you received any answers here? Maybe you can shed some light on the current status.

01:15:18 Armin Papperger

So, the first point about the EUR20bn. It is a clear task from the government they want to do it. But Mr. Cohrs, it's very clear that it depends about that how fast we get from the government the contracts. If there were still a delay of the order intake, yes, it would be hard for us to spend all the money because without contracts, we cannot start all the work. But the government wants and very clear our Chancellor says as soon as possible, we want to have the deliveries. And it should start in 2023, the bulk of deliveries should be in 2024. And this is a political decision because for sure the government wants to have also because they made the decision about the EUR100bn. They want to see some success. If it 100% comes and if we get the contract early enough, yes, I do not have the glass ball, as I said. But what I 100% know is that the government tries to do it as fast as possible. So the -

01:16:32 Christian Cohrs

Sorry, and you can also execute on the EUR20bn with let's say in three years' time.

01:16:41 Armin Papperger

We are able to execute because of the - we have now the capacities which are growing up on the, I give you one example about that. From the tactical vehicle side, we are able over the next 12 months to grow up from 300 to 900 vehicles on the tactical side. And we are growing up for German, or in total for the logistic vehicles from 2500 to 4000 vehicles. So this is what we did and there are the investments that we have done. On the logistic vehicle, it is done especially the painting areas, that we - where we invested the money. So there is the capacity and we are able to do it. It depends more on the contractual side.

01:17:31 Christian Cohrs

Okay. Understood.

01:17:33 Armin Papperger

The second question is we are in negotiations about milestone payments, because as you know, it is hard to get down payments from the German side. But the milestone payments, the Ministry of Defense and also BAAINBW is very open about that. So we are at the moment in discussions and I give you also an example. So if you produce a truck, that is it possible to get money for the engine, for the axle technology, for the chassis technology? That's right. Because otherwise our cash out is too big. So they are open about that. The government wants to help. We have no final decision. But I think over the next three months and in the next quarter, so we are one step forward and we can give you an information if we really do it, if they really do it or not. For me, it is absolutely a must and the pressure from our side is very high. Because otherwise we are not able to create this, what we want to do, a much better operational free cash flow.

Number three is on the Oto Melara side. There is at the moment no feedback because you see that the Italian government is struggling a little bit and if the Italian government is not in place, and the government has to make a decision so there is no decision what's going on. So we got no feedback about our offer from the Oto Melera side and my expectation is that we get an information latest in November when there is a stable government in Italy.

01:19:20 Christian Cohrs

That's clear. Thank you very much.

[1:19:24] Armin Papperger

A pleasure.

01:19:24 Helmut Merch

You're welcome.

01:19:28 Operator

And the next comes again from Sven Weier. Your line is open.

01:19:33 Sven Weier

Yes, just a few quick follow-up housekeeping ones please. The first one is coming back to the 2022 guidance, your guide for organic 15 and obviously we got a few M&A and currency impact here. I mean, it's a total round about 3% for the year, is that fair?

01:19:53 Helmut Merch

2 up to 3%. Yes.

01:19:57 Sven Weier

Okay. And then you kindly said, you know, the consolidation EBIT line and for the sales consolidation line is approximately EUR500m for this year and EUR600m for next year around about a fair ballpark.

01:20:12 Helmut Merch

I have to check my figures. In sales for 2022 is around EUR500m, up to EUR550m and for 2023, it should increase a little bit, around EUR600m or so.

01:20:35 Sven Weier

Okay, thank you. And then the third one is just in terms of how should I think about, you know, we obviously spoke at length about working capital build and so on. But how should I think about the pricing of these raw materials? I mean, you hold these now on stock for some time. What happens if the prices, and some of the raw materials have obviously now come down. I mean, do you see any writedown risks there eventually? Or is that something we shouldn't really worry about?

01:21:06 Helmut Merch

No, we are not buying all raw materials on physical stocks. We have our hedging policy in place, and I do not expect the same downturn as we see the recent increase. So, put it in a nutshell, we do not see any risk of writedowns in inventories.

01:21:32 Armin Papperger

And the reason is that most of the working capital is on the truck side and on the ammunition side, where we brought in the materials. So on the truck side, we expect that very soon we have now the contract, and we can deliver also end of the year. So it is important for us to have a fixed price for this material, so it is much better for us and because we know the price that we get for the truck. So we are in good shape in there. So there is a risk - it's a risk reduction from our side. On the ammunition side, it's very similar. So and we see a positive effect on if finally let me say we can rise and if we sign then the contract, if we can rise a little bit the prices, I think there could be a positive effect, not a negative.

01:22:25 Sven Weier

Good. And very finally, I know you haven't given the trading update for Q3, but maybe let me just try. I guess the year is probably very back end in orders. But is it fair to assume that the Q3 revenues should be around about the level of Q2 in total?

01:22:43 Helmut Merch

I give you a trading update for H2. We have to deliver on the top line a growth rate of roughly 24/25%. But I'm not kidding. So the growth rate in Q3 will be lower than Q4. We will have this year a very, very heavy back end loaded Q4 performance.

01:23:13 Sven Weier

Yes, that makes sense. Thank you both. Have a nice weekend.

01:23:17 Helmut Merch

Thank you. Bye-bye.

01:23:19 Armin Papperger

Thank you, bye.

01:23:23 Operator

There are no more questions. Ladies and gentlemen, if you'd like to ask a question, please press nine star on your telephone keypad. Please press nine star if you'd like to ask a question.

01:23:43 Armin Papperger

No further questions.

01:23:44 Operator

There's a question from Mr. Michael Raab. Your line is open.

01:23:49 Michael Raab

Yes hi, sorry to keep you from going into the weekend. It’s Mike Raab, Kepler Cheuvreux. I really have three very brief ones. First of all, in your previous slides, you would always have shown the item of the Marder successor. Where do we stand on this one? And then perhaps in conjunction with that second batch of Pumas, is this still expected to be between 100/150 units? And then ultimately, when it comes to the Fox successor, why would the government not choose the Fox 2 from your standpoint, given that the maintenance infrastructure, etcetera, etcetera, has been in place for the past four to five decades, but rather switch over to a completely new system, please?

01:24:35 Armin Papperger

The first point is, Mr. Raab, the Marder successor is a mixture between the Pumas which will come and the second lot of Puma with more than 100 vehicles. So the last discussion that we had was more than 110. And the other point is, as you know that the general or the chief of the army said very clear, he wants to have a mixture between Boxer with guns and between Pumas, so that this in combination will be the successor of the Marder. And the second question or third question that you had about the Fox, there is the Fox 2 that we offered on one side. And there is, as you know, and this was also in the press, cooperation between Patria and Rheinmetall. And the reason that the government is looking for that is that it says, but there is no decision. For us, it doesn't matter, because it's a lot of work for us anyway. If we produce the Fox 2, we will produce it here in Germany, and they need nearly 1000 if you know. If there is a Patria vehicle where we have to make a Germanization on one side, but the full production also. So the idea is to have a full license to produce it, because Patria has not the capacity to produce its vehicles, so it will be also for Rheinmetall anyway, the work. Then it’s the reason, a political reason, because we want to have a cooperation between the Nordic countries and Germany. So and if they make this political decision, then we will produce not the vehicles where we have 100% the IPRs beforehand. So we will produce a vehicle where we have 100% the license later in our end. So it's a decision from the government, but for us it doesn't matter which decision.

01:26:43 Michael Raab

All right, it sounds plausible. And just to follow up on the Boxers as Marder successor, but that is going to be a separate batch from the Schwere Waffenträger batch. Correct?

01:26:54 Armin Papperger

Yes.

01:26:56 Michael Raab

Thank you.

01:26:57 Armin Papperger

Schwere Waffenträger is around 100 and we need more of them. So this is very clear. And the Schwere Waffenträger deal should be a government to government deal between Germany and between Australia.

01:27:13 Michael Raab

All right. Thank you. Have a nice weekend.

01:27:16 Armin Papperger

We thank you, also.

01:27:18 Michael Raab

Thanks.

01:27:19 Operator

There are no more questions. There are no more questions

01:27:32 Armin Papperger

No more questions from our, you see nothing? So thank you, thank you very much. Thanks for the time, for Rheinmetall. I wish you also a very nice weekend. Keep out there and all the best. Hope we see you soon.

01:27:50 Helmut Merch

Thank you. Bye-bye.