Transcript of Webcast and Q&A session of Knorr-Bremse's Q2 2023 financial results

Date: August 10, 2023

Operator:

Hello, ladies and gentlemen, and welcome to the Knorr-Bremse AG Q2 '23 earnings call. 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, Andreas Spitzauer, please go ahead.

Andreas Spitzauer:

Good afternoon as well as good morning, ladies and gentlemen. I hope all of you are very fine. My name is Andreas Spitzauer, head of Investor Relations of Knorr-Bremse AG. I want to welcome you to Knorr-Bremse's conference call for the second quarter results of 2023. Today, Marc Llistosella, our CEO, and Frank Weber, our CFO, will present the results of Knorr-Bremse, followed by a Q&A session. The conference call will be recorded and is available on our homepage, www.knorr-bremse.com in the Investor Relations section. Here, you can find today's presentation and later a transcript of the call. It is now my pleasure to hand over to Marc Llistosella, please go ahead.

Marc Llistosella:

Thank you, Andreas, and welcome everybody to our conference call. Before we get started, I would like to take the opportunity to express my deep sorrow about the sudden death of Daimler Truck CFO Jochen Goetz. For me personally Jochen was a highly valued former colleague, always fair, always great. My heartfelt condolences, which I express on behalf of the entire Knorr-Bremse Group, go to his family, to whom I wish much strength at this difficult time.

Frank Weber:

Thanks for your kind words, Marc. Let me tell you that for me words can hardly express what I feel. I am deeply saddened about Jochen's sudden passing. Jochen was much more to me than a very longtime colleague in various functions. He was a friend! He was an exceptionally knowledgeable, persistent, pragmatic and trustful professional as well as an outstanding and down to earth individual. For me he was unparalleled in terms of reliability, integrity and kindness. I will forever miss him. My heartfelt condolences go out to his wife and kids as well as to my former colleagues at Daimler Truck.

Marc Llistosella:

Thank you, Frank. As usual, I will start with an overview of the highlights before Frank dives into the details, followed by a Q&A session. Let's kick it off on chart 2 with our main messages of today: Number one, we continue to see strong customer demand across all regions in both divisions. As a result, order books reached record levels and are a solid foundation of our outlook for 2023. Number two, as promised at the Q1/23 presentation and our strategy update in July: we saw a turnaround of profitability in the past quarter. This is a consequence of our successful Profit and Cash Protection Program (PCPP). Number three, together with Indian Railways, we could find a mutual solution to solve the technical issues with freight wagons in India and we concluded a settlement. We are therefore confident that the outstanding payments by Indian Railways will decrease near term. Number four, a meaningful part of our BOOST program is "Brownfield", which we presented to you in our strategy update. A major cornerstone of it is the focus on portfolio optimization. It took quite some time, but we could sign a deal to sell our Group subsidiary Kiepe Electric to Heramba. We are confident to close the deal soon. Number five, Let's talk about our company's efforts to fight climate change: We have increased our Scope 1+2 target to reductions of 75% by 2030. In addition, we have defined an ambitious Scope 3 target and we delivered on our commitment to obtain target validation through the Science Based Targets initiative (SBTi). This was a major step forward and shows our strong commitment to sustainability. Number seven, last but not least we confirm our Guidance and increased our revenue target for 2023 from 7.3 to 7.7 billion euros to 7.5 to 7.8 billion euros.

On chart 3, I want to share our market view with you and focus on 5 main messages. Overall, the good demand in the rail industry continues - driven by the political will to support green mobility. After Corona, ridership levels and rail traffic are recovering across the globe. As a result, aftermarket business grows and postponements decrease which results in high order books of our global OEM customers. The market in China is back and is already showing a positive effect on our AM business. The demand in Metro, however, is still challenging as the provinces and municipalities suffer from the weak real estate market and the accumulated debt burden of the past Corona years. The truck market shows high demand in Europe and North America. Truck production rates significantly increased in both regions in the past quarter and are also expected to grow slightly on a full year basis. Overall, in terms of demand, we hardly see any signs of weakening. In addition, Content per Vehicle growth is supportive for CVS. After the Chinese truck market struggled last year, we see strong recovery in 2023. CVS benefitted from this recovery due to our leading market position and leading position in the field of technology. In addition, there are good opportunities regarding content per vehicle, driven by rather lower safety standards and move towards innovative and reliable technologies also in China.

Let’s move to the second quarter KPIs on chart 4. All major financials moved higher year over year! The most important one for me was, that the operating EBIT margin is up by 60bps to 11.1% in the second quarter 2023. This development was driven by higher revenues and the success of our cost initiatives. In addition, order book reached a new record high with 7.1 billion Euros. It provides good visibility and confidence for the quarters ahead regarding utilization rates. Last, but not least Free Cashflow: It turned positive in Q2 as planned and we expect this good trend to accelerate further between now and the end of the year. I would now hand over to Frank for the financial insights.

Frank Weber:

Thanks Marc and welcome also from my side. Let’s move to chart 5. Capex in the past quarter amounted to 75 million euros, representing 3.7% of revenues. It was stable in absolute terms year-over-year, but lower in relation to revenues and currently well below our target range of 5-6%. I expect some higher spendings towards the end of 2023 as usual. Net Working Capital increased by roughly 180 million Euros versus last year’s level, but scope of days improved slightly year over year. I will go into more detail regarding this development on the next chart. I also believe that the level of 1.56 billion Euros should mark the peak in 2023 and that scope of days will strongly decrease in the second half year. ROCE for the second quarter 2023 increased slightly to 17%. There is still some way to go before we reach our target margin of more than 20%, but the development was definitely in the right direction.

On chart 6, I would like to provide you more details regarding our Free Cashflow, which was positive as expected and came in at plus 34 million euros in the past quarter, 69 million euros better than in the previous year. In the first half of 2023, the improvement even added up to around 100 million Euros. Traditionally, our Free Cashflow is significantly weaker in the first half of the year and 2023 is not an exception. The biggest impact on the development of our Free Cashflow is still the higher net working capital. The major driver for this was the increased accounts receivables among some larger customers, which tend to delay some payments. In addition, we maintain a high level of inventories in order to be flexible in response to customer requests and to ensure a high degree of supply security. Due to the further improving supply chain situation, we also expect the Scope of Days to improve. We have launched Project “Collect”, which is made up of cross-divisional teams such as direct/indirect purchasing, logistics, supply chain as well as sales and aftermarket, in order to systematically improve our net working capital.

Therefore, I expect in the quarters ahead, that we will improve, also driven by higher payments from Indian Rail again after finalization of the settlement. I am still confident, that Knorr-Bremse will reach its Free Cashflow Guidance of 350 to 550 million euros in 2023.

Let's take a closer look at the divisional performance in Q2, starting with RVS on Chart 7. In the second quarter of 2023, order intake in the Rail division was again very strong and above 1 billion Euro. The lion's share of this absolute performance was in Europe, followed by Asia and North America. The book to bill ratio is now above 1 for the 7th consecutive quarter and reached 1.07. This development will support the positive trend of RVS. It is particularly important for me to mention that the current price quality for new longer-term orders is the same as it was before the sharp increase in inflation last year. The order backlog as of June 30, 2023, amounted to 5.1 billion Euros, reaching again a new record high.

Let's move to chart 8. Revenues of RVS in Q2 amounted to 958 million euros, an increase by more than 16% year-over-year driven especially by Aftermarket business which outperformed OE business in the quarter. Additionally, price increases supported this development, too. Operating EBIT for RVS in the second quarter 2023 was 141 million Euros, up 19% year-over-year. As a result, the operating EBIT margin increased from 14.3% to 14.7% in the second quarter of 2023. The main drivers for our margin improvement were: First: Good operating leverage driven by higher revenues in all regions. Second: The aftermarket revenues in China, which increased double-digit year over year, because of the sharp increase in ridership following the end of the Zero Covid policy. We also recognized pull-forward effects on train maintenance. Therefore, it remains to be seen whether this level of the second quarter will be sustainable in the coming quarters. Last but not least, price measures and cost improvements could offset some of the inflation. We also expect a good development of profitability in the further quarters of 2023 due to a solid revenue development and further successes of the Profit and Cash Protection Program, but at the same time our forecast confirms, that RVS-margin for full year 2023 would be below last year's level.

Let's continue with our truck division on slide 9. Sustained high demand, which was already mentioned by some truck OEMs, has led to significantly increased truck production rates since the beginning of the year in Europe, North America and especially China. Incoming orders of CVS amounted again to more than 1 billion euros, which is an increase of 18% year-over-year. Main drivers for this significant growth were Europe and APAC, especially China. Both regions still benefit from good demand for transportation services. The order book of our truck division amounted to almost 2.1 billion euros, which is again remarkably 7% higher year-over-year.

Let’s move on to slide 10. Thanks to price increases and higher volumes, CVS posted a 15% year-over-year increase in revenues to 1.05 billion Euros in the second quarter of 2023. The division was able to increase revenues in all regions. Operating EBIT in our CVS division amounted to 98 million Euros in the past quarter, up 31.5 % year-over-year. As a consequence, the operating EBIT margin improved from 8.1% to 9.3%, due to the strong aftermarket business, the successful implementation of cost measures and higher customer prices. We are close to successfully finish our second round of price increases, our so called “Wave 2”, which will support CVS’s EBIT and EBIT margin starting from the current quarter. And with that I hand over to Marc for the guidance 2023 and some final remarks.

Marc Llistosella:

Thank you, Frank. I want to finish with our guidance for 2023 on chart 11. Our main assumptions are as always outlined on the right side of this page. As one aspect of those, we expect that all net extra costs due to inflation also this year will be once again compensated with our comprehensive PCPP measures. For 2023, we now expect an increased revenue target of 7.5 to 7.8 billion Euros. This uplift was mainly due to a higher, than expected, truck production rate and a better development of the aftermarket in the Rail Division. Furthermore, we expect an operating EBIT margin between 10.5% and 12.0% and a Free Cashflow between 350 and 550 million Euros.

As you can see Q2 results have shown first signs that we are heading into the right direction. We all know: One swallow doesn’t make a summer! We will use the following months to rigorously implement and execute our plan for value creation that we showed you a few weeks ago in our BOOST-presentation. We say what we do and we do what we say! So, the heat is on, and we will not cool off in autumn nor in winter. We announced a further relevant update of our roadmap to you for February next year. And rest assured we will deliver on time! Thanks a lot for your attention. Frank and I look forward to your questions now.

Q&A Session Knorr-Bremse AG

O Operator
AS Andreas Spitzauer
ML Marc Llistosella
FW Frank Weber
SW Sven Weier
AG Akash Gupta
GD Gael de-Bray
VM Vivic Mida
LF Lucas Ferhani

Operator: And the first question comes from Sven Weier, please go ahead.

Sven Weier:

Yeah, good afternoon. Thanks for taking my questions. First one is on RVS where you mentioned on the EBIT side that the price increases compensated high inflationary costs and Q1 you were still a bit more reserved on that in terms of only partial compensation. So, are you making quicker progress there in terms of the impact of the legacy contracts than you assumed so far?

Frank Weber:

Sorry for the delay. We had the technical issue here. Thanks, Sven, for your question. Basically, the plan going forward in regards to the degree of compensation of cost via pricing has not changed. Maybe a kind of understanding issue that we have here. **[17:00]** It's clear that last year overall we were able to roughly compensate 66% of our cost increases via pricing only. This year, we should overall for the whole group be able to achieve roughly 80% and towards next year, it will then again get better until it's completely consumed so to say. And this plan has not changed. It's gradually getting better but it's not fully compensated yet.

Sven Weier: But in Q2, it was, in RVS at least.

Frank Weber: Pardon, Sven? In Q2 it wasn't, it wasn't. It was compensating, but not to the full extent.

Sven Weier:

Okay. Because I just referred to the comment on the slide number eight where you said price increases and cost measures compensated higher inflationary costs, so maybe not fully.

Frank Weber: Prices and cost **[18:00]** measures, fully compensated, but not price measures only.

Sven Weier:

Understood. And then just on the second point, regarding China and ridership and reopening, were you also a bit surprised by this? Because on the strategy update, you sounded still a bit more defensive on China that you said aftermarket was already relatively sound also during the pandemic, so the catching up there was maybe not so much needed. I was just wondering what has changed between now and the strategy update?

Sven Weier:

I think the very general outlook, I wouldn't say we were surprised. We said that we do expect out of this change, drastic change of the Zero-COVID policy, some had tailwind on the aftermarket side, but not on the OE side. We still **[19:00]** see in actual results and also in our outlook for the full year in regards to the production assumed for Metros as well as for high speed trains, the same numbers that we have talked about just several months ago, Sven, we do think that maybe on the OE side, we can reach some 100 high speed trains throughout the year, and we can see the same level of roughly 5,100 Metros within China. So OE isn't the big leaver (19:32) for impulses in '23 for us, this is still confirmed. On the aftermarket side, a bit as ridership levels have really grown strong, they are in the first quarter and in the second quarter, which were even higher, above 2019 pre-COVID levels already. And this is a bit better than we thought indeed. Also, this resulting after-market business, including some pull forward effects **[20:00]** in the second quarter is stronger than expected.

Sven Weier: Could you quantify the improvement you saw in China sequentially on the after-market?

Frank Weber:

Yeah. It's a double-digit euro revenue number I would say in the quarter alone. And the big question out of that is you can hardly distinguish clearly what are really pull ahead effects from customers trying to get their shelves uploaded. This is difficult to say what's out of that kind of sustainable, but low to mid double-digit revenue figure in terms of million euros.

Sven Weier: Okay. Thank you, Frank.

Frank Weber: You're welcome, Sven.

Operator: And the next question comes from Akash Gupta. Please go ahead. **[21:00]**.

Akash Gupta:

Yes. Hi. Good afternoon, everybody. It's Akash from JP Morgan. My first one is on the guidance. So while you have raised your revenue guidance, but if you look at the implied second half, the midpoint is kind of implying flat year on year growth after you have reported 15% revenue growth in the first half. So can you elaborate, is this only because of the accelerated phasing of backlog in the past half? Or you just taking a more conservative view on the second half development? That's the first one.

Frank Weber:

I think that this distribution between the quarters and half year one and half year two has also not changed if we look at our forecast levels, in fact it's just a bit stronger. Quarter one and quarter two came in **[22:00]** on the CVS side. You know that we have been a bit more cautious potentially there over winter time and then giving you the guidance bit for CVS development. But we already back there saw that towards the second half of the year, it's getting a bit weaker in terms of revenues and this has nothing to do yet with a significant drop in other intake that we would expect. We have a quarter coming up, third quarter, which is usually a rather weaker one on the supplier side, at least as also our customers go into kind of summer vacation in regards to their plants. So this is typically a lower one. And the fourth quarter is still a bit out there. Given the current EDI numbers that we have, we also see it's a bit on the weaker side, so that hints to the imbalance that you point out in between half year one and half **[23:00]** year two.

Akash Gupta:

Thank you. And my follow up is on the guidance again from this Kiepe Electric divestment. And can you elaborate more on the financial implication of this divestment and whether there will be any impact that we should see later in the year?

Frank Weber:

First, of all, as we talked about the Kiepe overall isn't that much of a performing unit of ours that's the reason why we are in the current process. And as we are already now in August and we have baked in basically already six to eight months into our actual results that it'll not make a big difference so to say for our guidance levels, whether it will be closed in August or in October or so. If we could, so to say, **[24:00]** close the deal as soon as possible, there would be a slightly positive effect for the remaining months to come. That is clear, but this is not the make-or-break point for reaching our guidance.

Akash Gupta: Thank you.

Frank Weber: Thank you, Akash.

Operator: And the next question comes from Gael de-Bray. Please go ahead.

Gael de-Bray:

Oh, thanks very much. Good afternoon, everybody. I have two questions, please. The first one is about CVS. Could you quantify or at least provide more colour on the magnitude of the wave 2 pricing agreements, which were concluded in the first half? And then the second question is on the strategic program and following the update you had in July, I think it would be useful if you could provide some colour **[25:00]** and maybe regular updates on the growth and margin performance of the 1.4 billion euros of revenue that's under review and perhaps starting now.

Frank Weber:

Gael, thank you for your questions. First, the wave 2 that we're currently basically finalizing as we speak, this is in the dimension of similar magnitude like we have had in last year, so to say. But comes needless to say, on top as last year's negotiations have been also sustainably increased in the price levels. So similar amount to what we were talking about last year. Last year we were, we said kind of two thirds of the inflation compensated by pricing only on a group level, **[26:00]** two thirds of that last year came from trucks. And in that similar amount we are talking year over year than for the CVS colleagues in '23. That's the wave 2. In regards to the 1.4 billion that we talked about in the strategy update, it’s like you can also see back in the days on the slides that we showed in the margin walk, we roughly expect a level of 200 base points of EBIT margin improvement out of the respective counter measures, those not performing units that we're having. And they could either be selling those units or fixing them or bringing them up to the levels that we strategically target. So, we confirm it. We confirm what we said back then, 200 base points roughly.

Gael de-Bray: [27:00] Okay. I will do with that. Thanks very much.

Frank Weber: You're welcome, Gael.

Operator: And the next question comes from Vivek Midha. Please go ahead.

Vivek Midha:

Thanks very much, everyone. Good afternoon. I have two questions on demand. So, the first question is on rail. Your rail orders have remained to the high level so far this year. Do you expect to be able to continue to get orders at around that 1 billion per quarter run rate in RVS for the rest of the year? And maybe if you can give any updates on how your order pipeline is developing? Thank you.

Frank Weber:

Thanks for the question. We also do think that after now, I think more than four, five quarters in a row with more than a billion of order intake on the RVS side. And you also know this project business is not sustainable **[28:00]** work you can like cutting coupons forecast into the future. We do expect that order intake should be a bit lower moving in given all the tenders that are out there. We have the transparency basically all around the world in (28:16). Just given the tenders that are out there, we do expect order intake to go a bit down going into the next quarters. But this does not at all fundamentally change our core and strong belief of fully intact growing markets in RVS in basically all regions like we said, except for maybe China if we take OE here as a case. So this is the situation, a bit less order intake to be expected, but not at all change in the fundamentals.

Vivek Midha:

That's very helpful. Thank you. My next question is on trucks. With the **[29:00]** comments on trucks remaining at a good level, I was wondering if you could give any latest thoughts on where the truck cycle will develop into 2024, if you have any. Thank you.

Marc Llistosella:

So, when you speak about trucks, you speak about regions, right? So, in Europe we see a civilization on the high level, in North America, we see it the same, and in Asia mainly in India and especially in China, we extremely see a recovery. The question is now we see a slight slowdown in the recovery in China, we see a steady increase in India, which is unfortunately, not that important so far for us because this content of vehicle in India is not a third of what we are used in other markets. So the significance of this market will be an upside for the near future and the next future, but it'll not be a game changer for the next six or 12 **[30:00]** months to come.

What we see in China is that it'll be the question when the Chinese truck market is picking up to the level of the cars, and that is something which will come from our point of view, relatively erratic. It can be faster, it can be slower than expected, so we cannot say when it is coming. But one of the things for sure, you see the acceleration in the truck market by volume. And now the question is, when is the acceleration coming by content per vehicle and by the level of technology? That is the name of the game in China. It's less the volume itself, whether it's 700 or 800,000 units this year, it's more the question, when do we see that the latest technology will be built? And that's more a driver for the Chinese market. Besides the others, we are always, and you know that now, for at least the next six months, last six months, we have been a little bit modest and a little bit moderate with all numbers because if it gets better, **[31:00]** it's good for you, it's good for us, and if it gets what we expect, then it's okay, that's the baseline. So, we say we see no significant acceleration in growth in the key markets, Europe and EFTA, but we see a massive interesting shift will come up the next five years in China. So, for the next six months, it could not be, but it could be very, very easily the case in 12 to 18 months.

Vivek Midha: Thank you very much.

Operator: And the next question comes from Lucas Ferhani. Please go ahead.

Lucas Ferhani:

Good afternoon. Thank you. My first question is on RVS. There was a big step up sequentially in the margin, how do you see the margin moving going forward? Is it likely to be a bit more stable? Could it be a bit lower? I think you said there was some kind of pull forward of after-market demand in China, for example, that potentially could impact in H2. So **[32:00]** how do you see a little bit the margin development in areas specifically in H2?

Marc Llistosella:

Yes. I would like to start that. As you rightly said, we had a certain form of surprising uprise of the after-market in China, which was in fact good for our margin. But in order to be also very clear, even there is a certain form of downside in this, like a preponent. We can say that in the overall business, in the overall also in the OE business, we see a release of the pressure because now more and more of the new orders are coming into and falling into place. That means, as you rightly know, because we communicated this very clear, from the activated OE business this year, 31% of this business in RVS was to prices before Ukraine, **[33:00]** but costs after Ukraine. So this was a certain form of burden to the business. More and more in the year to come, we will see a release of this 31s for the whole year, and we will see new contracts coming into and falling into place. So this is more a tailwind. When you see the procurement of the after sales market and the orders and the billing in China for RVS, that is a slight headwind for us in the next six months to come, this would be a slight tailwind will come. But in 2024, we have only ten to 15% of the so-called pre-inflated pricing orders. That means the real kick in of the margin improvement will come then the next months to come, especially the next year to come. So, for the next half year, we don't expect any acceleration of our margin, but we don't see a massive increase **[34:00]** of the margin. What we see then for next year, is supported by what I just described. But Frank, please add to this.

Frank Weber:

Yeah. Thanks, Marc. Absolutely correct. Going towards the H2, I would guide you with the kind of level that is roughly on the H1 level. Which is potentially in a quarter even below quarter two level, but definitely above quarter one's level. So this is what we can see and as it's a project business, it's totally different kind of revenue scope that you would potentially have in the third quarter compared to the one that you would have in the fourth quarter. So that's just the kind of volatility that you of course have in the structure of the product mix.

Lucas Ferhani:

Perfect. Thank you for that. My second question is on the guidance. Again, you increased the revenues, very strong orders in H1 that gives you availability **[35:00]** into H2. You kind of know the moving path in terms of what's going to be the margins, I'm just surprised you're not narrowing maybe a little bit the EBIT margin guide. Seem quite conservative now to kind of be at the lower point. So, what risks specifically do you see which would lead to kind of a lower margin in H2 or you not being towards kind of the mid or top half of the range by the end of the year?

Frank Weber:

Basically, this is due to the fact that, so to say, that all of the negotiations wave 1, wave 2 you have in the meantime a very good back-to-back insurance in regards to inflationary cost increases. But at the same time also in regards to cost reductions that you would potentially see. So, you have to give away then also certain pricing once costs come down compared to your assumptions like **[36:00]** energy costs or personnel costs on our supplier side, tier two, tier three, tier four, what have you. If this is coming down, then you also have to reduce the price levels again towards the end customer. That's just the nature of the game. And as this is kind of still a situation that is ongoing, there's not so much fluctuation around the margin anymore. And I think with as a result of this, with the midpoint of the margin, you are on a safe side, so to say. And narrowing it down further compared to this, there's still issues out there in regards to the project dimensions on the RVS side, more or less. Which is of course not that plannable as there are big tenders usually out there and big deliveries out there which can easily so to say, cost a 50 basis point up or 50 basis point downside. **[37:00]** That's the reason.

Lucas Ferhani: Okay. Perfect. Thank you.

Operator:

Okay. So at the moment there seem to be no further questions. So if you would like to state another question, please press nine and the star key on your telephone keypad. I'll leave the line open for a couple more seconds.

Andreas Spitzauer:

Okay. In case there are no further questions, then thank you very much for your time and your attention. We wish you a great summer holiday. Looking forward when you are back, that we talk to each other again. And thanks a lot. Bye-bye.

Frank Weber: Bye.

Marc Llistosella: Bye-Bye.