Morgan Stanley 12th Annual Laguna Conference

Company Participants

- Judith F. Marks, Chairman, President & Chief Executive Officer

Other Participants

- Unidentified Participant

Presentation

Unidentified Participant

Thank you, everybody. Super excited to be up here with Otis Worldwide. We have Judy Marks, Chair, CEO, and President. I think, Judy, were you going to read the disclaimer?

Judith F. Marks {BIO 5075554 <GO>}

Yeah. Thanks, Chris. Please note, except where otherwise noted, I'll speak to results from continuing operations, excluding restructuring and significant non-recurring items. A reconciliation can be found in our second-quarter earnings presentation on our investor website. We also remind listeners that today's discussion contains forward-looking statements. Otis's SEC filings provide details on important factors that could cause actual results to differ materially.

Questions And Answers

Q - Unidentified Participant

Thank you. So yeah, maybe just kind of hopping right into it. So it's been a challenging year in the new equipment market for everybody. Where do you -- where does that market stand today? And from a regional perspective, what are you seeing, where is the most risk?

A - Judith F. Marks {BIO 5075554 <GO>}

Yeah. So listen, as we came into the year, we knew new equipment was going to be challenged. And our opinion right now is pretty much the same with the exception of one region. As we look at the Americas, we came off COVID, we had a really strong couple of years and really proud of the team and how they performed, built-up the backlog that's been giving us this really good sales -- sales drive for new equipment. '23 was a challenging year down in the teens, more so in North America than Latin America and '24 looks a little better than '23, but we're still seeing some projects being held.

We think rates has something to do with that so we've seen some increased activity in the past few weeks that we think the second half is going to look better for us than the first half. In Europe in terms of the market, it was down high-single-digits last year and this year is low single. And we've performed fairly well there, matter of fact, our orders are up for a few running quarters.

When we look at Europe, especially the geographic split, Middle East looks the best, followed by Southern Europe and then really followed by Western and Northern Europe. Asia-Pac, just as we expected is up. The market looks really strong. We've been held back last year a little because of Korea, but Korea is starting to normalize a lot better. But you look at India, you look at Southeast Asia, just high-growth markets, especially after the national elections in India. I was just there two weeks ago and business is really doing well.

Infrastructure sector actually across the globe is doing well. So all three of those are really performing as we expected in terms of market and the biggest change has been China, where we came into the year -- I mean, this is the third year in a row where the China market is down 10% for three running years. So the segment itself now is about $425,000, down from a peak of $600,000 on new equipment. Our team has really figured out that blend of how do you optimize price and volume while still driving costs down in a deflationary environment.

But it's really that China market not recovering for a third straight year that really caused us to pause and actually to take our guide down in terms of top-line.

Q - Unidentified Participant

Yeah. Maybe just kind of following up on China. Are you seeing any rate of change in that market? And then within China, are there any specific verticals that are particularly weak or any that are actually sources of green shoots?

A - Judith F. Marks {BIO 5075554 <GO>}

So infrastructure remains strong. It's the most positive market in China. And in the second-quarter, I would tell you both infrastructure and industrial, the segments themselves were strong. Resi is still -- it's still really down, but that's where a lot of the volume is. Tier-1 and Tier-2 cities are doing better than the lower-tier cities. And then we also find that key accounts, which was a strategy we put in place to be able to get more national accounts to be able to get that service stickiness. That stayed strong as the developers have consolidated, but the market itself in China between credit and liquidity is challenged.

Now other green shoots for us is clearly this pivot we've made and the strategic decision we made at Spin to focus on service in China. And so if you look at our business in China, what used to be 20% of Otis's revenue just a few years ago, this year, China will be 14% of Otis's total revenue. And of that, because we've pivoted to service, kind of 10% of Otis's revenue will be China new equipment. So its impact on us has become smaller and smaller. It's our highest-margin new equipment market. Our mod market in China has the same margins as new equipment. We're seeing green shoots there. I'll be happy to talk about it as we go.

And our service market, those margins are higher than new equipment, a little less than mature markets, but we've doubled our service portfolio in China in 4.5 years. We had about 200,000 units when we became independent again. We ended last quarter at 415,000 units. We're growing at mid to high single digit. And in doing that, we're gaining the density that's giving us better profitability and it's also giving us the ability to -- even at that, we have 4% market share. There's tremendous opportunity for us in service, in modernization, which I'm sure we'll talk about and new equipment even at 400,000, 425,000 units, it's still a good market. We just -- it's very competitive and we're being very selective.

Q - Unidentified Participant

Yeah. I mean, I find you guys to be smarter on the Chinese construction market than any company I cover. So I want to ask, what do you look for to give you confidence or what will you be looking for to kind of say, okay, things there might be turning like, what should investors be looking for?

A - Judith F. Marks {BIO 5075554 <GO>}

Listen, anything the government can do from a stimulus, from a rate perspective, I've got to give the Chinese government a lot of credit. They've been trying, right? They've been trying multiple items to stimulate real-estate and property development sales. And it's really important because the local governments get their revenue based on land sales. And if they can't sell the land to the developers, then there's some other revenue challenges for all the local governments. I go to China quite a bit. I'll be back in November. I was already there once this year. We're celebrating our 40th year in China. And we still have a great group of colleagues, almost 16,000, 17,000 there that are dedicated. Again, far more on the service side, that's now a third of our revenue in China. So we've been going through this change.

On the property side, there still remain 450 million Chinese who are living in poverty in rural areas and the government has made a stated focus on bringing a couple of hundred million more. The Chinese population, as everyone knows, is aging. Aging is a mobility opportunity for us. People need lift, they need help and whether those are units that don't have elevators where we're literally installing elevators on the outside of the building, there are a million seven-story walk-ups in Beijing and Shanghai for us to approach or whether those are just people moving to different housing arrangements in China when you have a house, that means you're vertical. So yeah, we're cautious.

We think anything the government can do would be helpful, but we're doing a lot of self-help ourselves. It's a deflationary environment. We're driving cost out, we're driving for productivity so that we have the ability to compete.

Q - Unidentified Participant

Yeah. And maybe just kind of following-up on China. You mentioned China is your best margin market for new equipment. You've had mix headwinds without dragging growth lower, but the company has been able to have pretty impressive new equipment margins despite that. So I guess kind of one, how are you able to do

that? And two, how is portfolio growth in China remaining so strong with the new equipment market under so much pressure?

A - Judith F. Marks {BIO 5075554 <GO>}

Yeah. Let me start with the first one, which is this mix challenge. The beauty of the Otis business is a third of our revenue is in Asia, a third of our revenue is in Europe, and a third of our revenues in the Americas. And it gives us that ability for the other businesses, be it the Americas, EMEA, or Asia-Pacific, really to have the ability to counter when we run into challenges in China. So the beauty -- what our team has been doing in those markets is gain share and get price.

So we've been getting kind of mid-single-digit price on new equipment in the Americas and EMEA. We've been getting flat to low-single digits depending on what part of Asia it is, mature Asia, whether it's Japan, Korea, Australia, or growing Asia, which is Hong-Kong, India, Southeast Asia.

So the other three businesses have picked up because as you look at our business, even though this year, our new equipment organic sales will be down, our organic sales have continued to grow. And with all of this happening, despite China being the largest profit generator for new equipment, we're still at 7% margins and for new equipment. And you look at how that drops through and the EPS we've been delivering year-after-year now for four years has been 10% or better and we're guiding 9% to 10% this year. So drive costs down, the other three regions are growing nicely, getting price, growing share, and delivering.

Q - Unidentified Participant

Yeah. And last one on China. Obviously, the new equipment market is under pressure, but the installed-base there is aging. What do you see on the mod opportunity in China looking-forward?

A - Judith F. Marks {BIO 5075554 <GO>}

Yeah. So China is the single largest installed base anywhere in the world, think about 10 million units in use every day. I shared with you we have about now have a little over 4% market share. So there's plenty of opportunity for us on portfolio growth, either with these key accounts, of the 415,000 units, 250,000 have Otis ONE. So we're connected. We've got the stickiness. We've increased our conversion rates from what's little about 40% at spin. Last year we ended 51.7% on our route to 60%. So we're growing our service business through a variety of levers.

The exciting part about China is, if you think about when China urbanization happened, kind of started in 2000 and it's been running ever since. You could have peaked in 2021 at about 650,000 new equipment units. But through that period, there have been a tremendous amount of units installed. And in China, at about the 15-year point, that -- those units have gotten so much use that they are in need of a technology refresh, a refurbishment, just like you would do with your car, what you would do with your white goods in your house. So as we look at it, we're entering a new stage of modernization in China, which this year alone, 800,000 of those 10

million units are 15 years or older. And every year following, you're going to add a couple of hundred thousand and then the next year, 300,000, next year, 400,000, it's going to be a huge modernization market.

And the neat part about the China mod market is because all the units are kind of the same technology vintage between 2000 and 2024 right now, as you modernize them, it is a new equipment role all over again. You're going to take out almost everything as we do with most mods, except the guardrails, perhaps the landing doors on each floor. And you can put a whole new technology refresh in, a whole new cab, a connected unit, new machines, new controllers and when we do that in China, it's going to look just like new equipment. We're handling it already out of our factories. So we're getting all the supply chain efficiencies and that's why mod margins in China right now are the same as new equipment margins in China, which are our highest.

Q - Unidentified Participant

So I know a lot of times people focus along the new equipment market, including the first few questions I asked, but it only represents what, 15% to 20% of company operating profits. Otis is driven by service.

A - Judith F. Marks {BIO 5075554 <GO>}

Yeah.

Q - Unidentified Participant

And I think the biggest concern that we hear from investors is what is the ability for the maintenance portfolio to kind of sustain 4% growth through a new equipment downturn, which continues to look like it could be extended. How sustainable is that 4% growth deal?

A - Judith F. Marks {BIO 5075554 <GO>}

Yeah. It's a great question because not only is it sustainable, we're not satisfied at 4%. So if you think about the market itself in the segment, there's kind of a two-year plus lag between when units are booked and ordered, shipped, installed and warrantied. So we still have 800,000 to 900,000 units a year entering service somewhere in the world. That's a mid single digit growth for the market segment itself. So even at 4%, you could argue we're not at-market segment growth. So we know what we need to do. I'm pleased that we got to 4%. We were perennially much lower, but we've now had multiple years, multiple quarters where we have the ability to do this.

We've got 2.3 million units under service today. A 4% growth gives us another 100,000 units every year. And they add two key dimensions. The first dimension is density. When you add a unit, you can be more productive on the route, the mechanics can be more productive, our digital tools can be more productive. So those units incrementally are far more attractive to us as we add them -- those 100,000 units in the world. But the second thing it does is it gives us the ability again to spread fixed costs, to drive margin expansion, to drive productivity efficiency. And

in 4%, again, 100,000 units, we should be doing better and there's probably six different ways we can do better and that's what we're working on.

The first is retain units more. Our retention rate is just under 94%. It's the best in the industry, but other service route-driven industries, we've seen some best-in-class in the world get to 96%. So we want to get to 95%. And what that point drives, again, when 90% of our margins are service, what that point drives, actually with the 4 points -- 4% drives and then just add a point to it is that much top-line growth for the next year when you have your service -- your service -- your maintenance contract. So you're going to get on maintenance, you're going to get 4% plus price, maybe a point or two of price.

And then we also have a recurring repair business that happens with it that we tend to say is about one to two points better than maintenance. So that's what gives us this mid-single-digit plus organic growth in service almost as an annuity just from new equipment. So we convert units, that could give us another 0.5 point. Retention rate gets up to 95, that could give us another point on the portfolio. We recapture units that are not in our portfolio today. That could give us another 0.5 point. I know we don't have time for me to go through all the math. I'm happy to do it with anyone. So we can see something much higher than four. It's not all going to happen at once and it's not all going to happen in every part of the world.

But every part of the Otis portfolio is growing this year. And that 100,000 gain, it's more skewed to China because we're growing our portfolio there, mid to high teens. So with that comes a little bit of a mix, but I'll take that mix any day because the more we add, we get the density, we get the profit and we balance that.

Q - Unidentified Participant

Yeah.

A - Judith F. Marks {BIO 5075554 <GO>}

And then if you add MOD, so that starts the flywheel, right? New equipment, convert it, retain it, that's the flywheel. Then you hit this 20-year point in most of the world 15 years in China and then you have another entry point because you do a technology refresh, that technology refresh then starts the clock again. If it was already on our portfolio, which is about 60% of the MODs we do today, then that stays in the portfolio. That's not a gain. But the other 40% are non-Otis units or units on other people's portfolio, we do the MOD so we get the revenue for the mod, we get the margin for the mod and then it triggers that adding to our portfolio.

So I can see a number a lot higher than 4% and it's -- that is going to be the growth engine. And on MOD, and I think it's a little bit of a misperception some folks may have, but in the past, it was small and it was custom. But now we've industrialized it. We introduced MOD as another strategic imperative at Otis last year so that we could focus on it. And I wanted our team to get the opportunity to have some runtime. We organized specialized sales reps. We taught our installation teams what they needed to do. But most importantly, we decided we were going to industrialize and package MOD.

So we have a product we call Gen3. We sell it almost everywhere in the world now. We just rolled it out in Southeast Asia over the past few weeks in multiple countries and we have Gen 360. Our MOD packages and kits are going to be manufactured as Gen 3 MODs. And they're going to be the Gen 3, they're going to be connected, they're going to be our new machine, our new controller, our whole new system. They come across the same line. We've got the same installation crews. So you get all the optimization and that's how now six quarters into our MOD strategy, we've been able to have MOD profitability surpass new equipment profitability. So new equipment is at 7, last two quarters, mods higher with MOD going up to 10 due through the medium-term.

So for us, you think about units and everybody talks as you started about new equipment units, but the MOD units are coming across the line at the same time. Their units too, they drive the same top-line per unit because they're about the same price because we have to take out the old unit and put this in, so we get the same revenue at higher margins. So what excites me about MOD is we've got a larger market opportunity organic with a smaller group of competitors because most ISPs don't do MOD and that market is going to grow high single to double-digit for years to come.

And for us, it looks like-new equipment, but it allows us to just start the flywheel all over again. So that's really what's exciting. And if you think about construction cycles, 3 million units in EMEA over 20 years already, 1 million-plus in the US, 1 million-plus in Asia, 800,000 over 15 years in China, that's a lot bigger than an 800,000 unit new equipment market and that's where we're going to get lift.

Q - Unidentified Participant

You know, you -- we've seen really material improvement in recaption or recapture retention and then even MOD over the last, I guess, four or five years since you guys have been an independent company. Is that just a function of being a more focused independent company? I would imagine Otis ONE brings a lot of tailwinds to that. Why are we seeing this improved aftermarket business?

A - Judith F. Marks {BIO 5075554 <GO>}

I think the focus -- the spin thesis of focus is we're validating and we're validating it every day. But what the focus is, is a focus on strategy, focus on investment, and a focus on your people. And when you focus on all that and our teams and our colleagues focus on the customers, that's when we've been able to yield these results to gain market share. So you start with coverage, you make sure you have enough of your own sales force and agents and distributors. We've done that throughout the globe. We've grown our own sales force significantly because when we have someone that can see a bid and we have the opportunity to bid, we win more.

We've expanded agents and distributors primarily in China, but in other countries where we may not have the reach. We've doubled that for new equipment, service, and mod and they're performing well even in a challenging environment. They're motivated. We're working together very well. All that helps us, again, to create an

environment where our teams can deliver with operational excellence every day. Every day, we've got about 200,000 service calls going on somewhere in the world and about 10,000 installations. We used to call new equipment installations. I'm going to stop using some of these terms because you're going to see new equipment and MOD kind of converging on installations. So we'll get to a new number there.

The strength of Otis is that ability to throughout the globe simultaneously with technology be able to deliver for our customers. And that's what gives us the largest service portfolio, the largest business, and allows us to be the leader, assuming we continue to innovate, which we've done, we've made investments. We spend about a 1.5 on R&D. We're not a -- it's a long-cycle life safety business. We spent about 1.2% on CapEx. So we're really capital-light investment light, but a really great resilient annuity service business that kind of drives everything we do. And it happens through our 42,000 field professionals and they make a difference. Now, we can't do that. We can't make them more productive without giving them tools and technology.

And so whether we go back a few years and they were the applications that help them, or their route optimization or applications that help them, we put a tune app on the floor of an elevator and it gives them noise and vibration, tells them if it's within the guidance or if not, what part they need and what to align. But Otis ONE has probably been the biggest game-changer for us. It is an IoT-connected platform that gives everyone in an ecosystem visibility. Our customers have a customer portal. In China alone, we've got 45,000 customers on our customer portal that can see the status of their elevators no matter where they are.

In Japan, we have to have earthquake sensors, ironic, if we were all here this morning, but they're required in Japan. In our Otis ONE app in Japan, as soon as the earthquake or the tremors end, the customer can see their campus, they can see their buildings, is my elevator operational? And then they can see as we respond. And it just -- it gives us tremendous visibility. And I'll just give you two quick examples on Otis ONE. In China where, again, we have 415,000 units, well over 200,000 of those are connected via Otis ONE. A lot of times our call centers get a phone call that says my elevator is down.

Well, our call center as part of the ecosystem, and the mechanic have instant visibility and we can say, no, we can see it's running again. So we stop a truck roll. You can imagine the productivity and most importantly, the customer is running again. We can say in some -- certain jurisdictions, we can remotely fix it where code allows. So that's easy technology, again, where regulatory code allows or we can say, if you just push in that emergency switch or unblock the door because we have a door sensor, then you'll be running. You don't need to wait for our mechanic. And so what our customers want is that uptime. They want it to be operational. And what we found in China, we get about 15% of all the calls that come into our call center are what we call running on arrivals.

When we go historically, it's already running when we get there. It's very -- it's frustrating for everyone and it's not very productive or efficient for us. We've already been able to cut that in half, and we should be able to get to most of them. Second example in Germany, a lot of residential. Think about Europe as a big residential portfolio. In certain countries like Germany, you don't have a mandated, every month you need to do scheduled maintenance. So by using Otis ONE, by collecting all that data in a data lake, by using data analytics and AI, we have the ability to say to monitor and say, that unit has gotten very little usage over the past few months.

So either you don't have to go when you thought you would for scheduled maintenance or when you go, instead of the standard checklist, you really only have to do these five because the doors haven't been -- the door operator may not need it or anything. So we are seeing productivity gains, but the customer stickiness has been amazing. Our retention rates when we have Otis ONE in China alone where our retention rates are challenged at times, we've cut that in half that difference there in terms of customers, we've actually doubled our ability to work with them and we're seeing that across the globe.

Q - Unidentified Participant

How do independent service providers compete with that?

A - Judith F. Marks {BIO 5075554 <GO>}

So they don't have ecosystems. They may get some sensors, right? I mean there's ways you can put sensors. Yeah, but at the end of the day, 10 million units in China, 22 million units in the world. Of those 22 million units, 55 are serviced by independent service providers. There's plenty of maintenance work to go around and competition is a good thing.

There's plenty of maintenance work to go around. But the way we've been growing the portfolio is by taking that away from them, giving the customer a better value proposition, and being able to secure that customer.

Q - Unidentified Participant

Yeah. I guess maybe looking out over the next year, and I know we're not providing guidance, but what do you see as the biggest sources of upside over the next year and what do you see as the biggest sources of downside risk over the next year?

A - Judith F. Marks {BIO 5075554 <GO>}

So the -- I mean, there's two major sources of upside. And I think we've managed the items we can control. I think we've shown for the past 4.5 years since spin, we know how to control them. We've become more productive, we've become more efficient, and we've obviously grown our customer base significantly, whether it's through new equipment share or through service portfolio growth.

The service portfolio is the most important part of our business model. It's the most important part of who we are. It's what sustains us in hard times because it's an

annuity as long as we continue to perform and it gives us that opportunity to add services to it, whether it's repair or modernization.

Modernization right now, our backlog as of last quarter was 17%. So we're going to probably -- we will probably end the year with a double-digit backlog in modernization. I feel really comfortable saying that we've had six straight quarters of double-digit orders in modernization and it's been in every part of the country -- every part of the world. So it's not one region. It's really nice to see that MOD now. We put a strategy in place, we operationalized it and our team is performing. That's going to continue to grow, that market is going to continue to grow. So we'll have that backlog going in.

On the risk side, we're going to -- we think we're going to come out on new equipment orders in the second half of the year, certainly better than the first half. And based on what we see, we think we could end the year with new equipment down one to maybe flattish depending on how orders come in for backlog. That gives us really good line of sight for 2025. And we'll see where interest rates go. We'll see where things happen and sentiment means a lot. It means a lot in China. It means a lot for developers here. The average building in the United States is -- 80% of the market here is eight stories or less.

I know for those of you that live in the major metro areas, that may sound a little off. But this is a low-rise market. We introduced a brand new product to address this market that's picking up well. Those projects, we think, and what our sales teams are hearing, especially in the Midwest and other places, they're going to take off. And it's just -- people are just waiting for that signal and we hope that and we believe that will happen soon. But China is still hard to call. I mean, I'm going to be very transparent. China is just still hard to call. What I will say is our China business was $2 billion in 2019, that same China business after now almost three years of 10% new equipment decline ended last year at $2 billion.

So this service pivot is proving itself out. It's going to take some time, but modern service in China is going to pick up and modern service is going to pick up everywhere. So price, we probably won't get as much price with inflation coming down in different parts of the world, but our costs will come down too, whether it's on the commodity side or especially with labor. And I think we've shown now for 18 quarters, we know how to drive enough productivity to offset those labor costs.

Q - Unidentified Participant

Maybe last one here. Oh, sorry.

Sorry. Max from (inaudible). Could I just ask a quick question on how easy is it in modernization to convert someone else's elevator? So how much of an opportunity -- is it only your own installed base or is it others?

And I would imagine just secondly, I guess, I would imagine a lot of people are focused on modernization given the weakness. So could you just talk a little bit

about how pricing is trending in China modernization relative to the new equipment?

A - Judith F. Marks {BIO 5075554 <GO>}

Yeah. So first, how simple is it? It depends how much of a modernization you're going to do, but the majority of the modernizations we're seeing, which is why to me and what the data we're seeing says mod price equals new equipment price unit per unit, geography per geography on parity is the majority of what you're going to do is you're going to take the cab out and you're going to take all the old technology out or you're going to take a hydraulic unit and convert it to traction.

When you do that, you literally leave the rails because they're fine, right, the steel rails that are in the hoist way and you may leave the doors, you may leave one or two other things, but you're basically doing a full-on replacement.

The how easy question I would tell you means if it's someone else's portfolio, we're going to have to compete to win it versus the ones on our portfolio, a lot of those will come to us just because we're there, our mechanics are there, our service sales people are there. We've been maintaining them for 20 years, a lot more of those will get sole-sourced. So that's where kind of the 60-40 comes in that we've been experiencing.

But I like the 40 because even if the MOD comes in where we like it on the margin at new equipment or better, we're going to get that on the portfolio. So we're going to get the benefit of that.

The second question was?

Q - Unidentified Participant

The pricing.

A - Judith F. Marks {BIO 5075554 <GO>}

Pricing in China or pricing in mod in general?

Q - Unidentified Participant

MOD modernization (Technical Difficulty).

A - Judith F. Marks {BIO 5075554 <GO>}

Well, again, with 10 million units to maintain in China, all those -- most of those ISPs, if not almost all, are small and local. There's no national champion, there's no even citywide. You won't find one ISP that does all of Beijing. They're just not that large. So it comes down to really the OEMs who are going to do modernization.

Of the OEMs, there's about 10 of us have 90% of the new equipment share. So you're not talking a lot. And we really don't see -- again, if you're an ISP, you don't

have access to the equipment to do the MOD. So you have to buy it from someone else.

Now they may do that. And -- but you won't see those 10,000, 15,000, 20,000 ISPs. They'll have plenty of work to run out their companies for a lot of years on maintenance, and we haven't seen them really enter the MOD market significantly.

Q - Unidentified Participant

Well, we're up on the 30 minutes. Thank you so much, Judy. Love the conversation and appreciate your time.

A - Judith F. Marks {BIO 5075554 <GO>}

Great. Now I'm really glad to be here. And just remember, think of us as a service company.

Q - Unidentified Participant

The operating profit would tell you that.

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