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Otis Worldwide Corp. (OTIS)

Q1 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Otis' First Quarter 2023 Earnings Conference Call. This call is being carried live on the internet and recorded for replay. Presentation materials are available for download from Otis' website at www.otis.com.

I'll now turn it over to Michael Rednor, Senior Director of Investor Relations.

Michael Rednor

Senior Director-Investor Relations, Otis Worldwide Corp.

Thank you, Didi. Welcome to Otis' first quarter 2023 earnings conference call. On the call with me today are Judy Marks, Chair, CEO and President; and Anurag Maheshwari, Executive Vice President and CFO. Please note, except where otherwise noted, the company will speak to results from continuing operations, excluding restructuring and significant non-recurring items. A reconciliation of these measures can be found in the appendix of the webcast.

We also remind listeners that the presentation contains forward-looking statements which are subject to risks and uncertainties. Otis' SEC filings, including our Form 10-K and Quarterly Reports on Form 10-Q, provide details on important factors that could cause actual results to differ materially.

With that, I'd like to turn the call over to Judy.

Judith F. Marks

Chair, Chief Executive Officer & President, Otis Worldwide Corp.

Thank you, Mike, and thank everyone for joining us. We hope everyone listening is safe and well.

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Starting with first quarter highlights on slide 3. Otis delivered a solid first quarter to start 2023, driving strong financial performance and executing on our capital allocation strategy despite continued market uncertainty. We achieved organic sales growth driven by our Service business and expanded adjusted Service operating profit margins by 40 basis points, leading to mid-single-digit adjusted EPS growth. Our Service segment performance, in addition to our maintenance portfolio growth of more than 4%, reinforces the strength of our business model.

We continued to execute our balanced capital allocation strategy with $175 million of share repurchases in the first quarter. Yesterday, we announced a 17.2% increase to our quarterly dividend. Since spin, we have increased our dividend 70%, emphasizing the importance we place on disciplined capital management and delivering value to our shareholders.

In the Americas, building on our strong track record of major project execution in Service across Canada, Otis was selected by the Montréal Metro System to replace escalators at 17 stations while providing units for five new Blue line stations. In total, 97 Otis escalators will keep metro passengers on the move daily.

In China, Hefei Metro placed a new order of 250 Otis ONE connected escalators and elevators across three new lines. Real-time data insights, remote monitoring, and predictive maintenance will all help bring the Hefei Metro into the future and add to our growing infrastructure installed base.

In Germany, Otis has been selected by SIGNA Group to modernize the iconic Düsseldorf department store Carsch-Haus as part of a larger renovation. Otis will provide 17 units, including our energy-efficient Link escalators and Gen2 Stream elevators with ReGen drives. The elevators will also feature eView in-car displays. After the modernization is completed in 2024, Otis will service the units as part of our long-standing framework contract with KaDeWe Group which operates Carsch-Haus and other leading department stores in Germany.

In South Korea, we're providing 51 of our signature Gen2 elevators for the Suncheon [indiscernible] (00:04:04) luxury apartment complex. The campus includes more than 2,000 units in buildings up to 29 stories.

And we continue to drive progress towards our ESG goals, as shared in our 2022 ESG Report published earlier in April. Just this month, we announced the installation of solar panels at our Nippon Otis logistics and engineering center in Japan. This upgrade is expected to reduce greenhouse gas emissions at the facility by 27% compared to 2022 and represents our eighth manufacturing site globally with solar panel arrays.

Moving to slide 4, Q1 results and 2023 outlook. New Equipment orders were up 7.4%, driven by strong growth in the Americas and Asia Pacific, and we ended the quarter with adjusted backlog up 10% at constant currency. We continued to drive share gains in New Equipment with 70 basis points of improvement in the quarter led by our outperformance in China where our orders were down modestly in a market where we estimate was down approximately 10%. We continue to perform well across all other regions.

We're especially encouraged by our modernization performance in the quarter, with nearly 30% orders growth driven by strong performance in the Americas and Asia. This growth is driven by our continued roll out of standardized packages for our mod offerings, coupled with improvements in our sales force coverage. Our mod backlog is up double-digits in all regions as mod demand continues to remain robust. Organic sales were up 3.6% and adjusted operating profit was up $7 million at constant currency driven by performance in the Service segment.

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Before I discuss our 2023 financial outlook, let me briefly update you on our global market outlook which largely remains unchanged. Entering the year, we expected global New Equipment to be down mid-single-digits to approximately 900,000 units, largely due to China, which we expected to be down 5% to 10%; and our outlook in that key region remains the same. We also expected Asia Pac to be up mid-single-digits or better, and both the Americas and EMEA to be flat.

With the first quarter in the books, we now expect Asia Pac to come in closer to high-single digits, offsetting reduction in our EMEA outlook which we now expect to be down low- to mid-single-digits. Our outlook for global installed base growth remains unchanged at roughly 5%, which will add close to 1 million maintenance units, bringing the installed base to roughly 21 million units with high-single-digit growth in Asia and low-single-digit growth in the Americas and EMEA.

Turning to Otis' 2023 financial outlook. We now expect net sales to be in the range of $13.9 billion to $14.2 billion, up 2.5% to 4.5%, versus the prior year, which is a 75 basis point improvement from the prior outlook at the midpoint driven by FX. We still expect organic sales to be up 4% to 6% with New Equipment up 3% to 5% and Service up 5% to 7%. Adjusted operating profit is expected to be up $90 million to $150 million at actual currency and up $130 million to $175 million at constant currency, with adjusted EPS in a range of $3.40 to $3.50, a 7% to 10% increase versus the prior year and an approximately $0.03 improvement from the prior outlook at the midpoint.

We expect free cash flow to come in as we guided in February, in a range of $1.5 billion to $1.55 billion, with 105% to 115% conversion of GAAP net income. We remain disciplined in our capital allocation strategy and will continue to return the vast majority of our cash generation to shareholders through dividends and share repurchases. We will also continue advancing our bolt-on M&A strategy to add density to our growing maintenance portfolio.

With that, I'll turn it over to Anurag to walk through our Q1 results and full year outlook in more detail.

Anurag Maheshwari

Executive Vice President & Chief Financial Officer, Otis Worldwide Corp.

Thank you, Judy. Starting with first quarter results on slide 5. We delivered net sales of $3.3 billion with organic sales up 3.6%. This represents our 10th consecutive quarter of organic growth with better-than-expected performance in both segments.

Adjusted operating profit was down $19 million at actual FX and up $7 million at constant currency. Drop through on higher Service volume, favorable Service pricing and traction reproductivity in both segments were partially offset by inflationary pressures including annual wage increases, new equipment mix, and higher corporate costs.

Adjusted EPS growth of $0.04 in the quarter was driven by stronger operational performance, continued tax rate improvement, and a lower share count. Accretion from the Zardoya transaction offset the $0.04 of foreign exchange headwind.

Moving to slide 6. Q1 New Equipment orders were up 7.4% led by Asia Pacific and the Americas up 27% and 15%, respectively, with modest growth of 1 point in EMEA more than offsetting a 3% decline in orders in China. Strong orders growth has contributed to our adjusted New Equipment backlog increasing 10% at constant currency with growth in Americas, APAC, and EMEA. China backlog was roughly flat. Our strong backlog provides New Equipment sales visibility for the balance of the year, as well as over the medium term.

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Globally, pricing on New Equipment orders was up mid-single-digits, leading to sequential backlog margin improvement in all regions. We benefited from pricing increases of approximately 10% in the Americas and mid-single-digit in both EMEA and APAC. While pricing in China remains competitive, down low-single-digits, we are driving material productivity to achieve slight price/cost favorability in the region while continuing to increase our share.

New Equipment organic sales were roughly flat in the quarter with 22% growth in Asia Pacific driven by strong performance in India and Korea, and high-single-digit growth in EMEA largely from Southern Europe. This growth was offset by a mid-single-digit decline in the Americas due to jobsite delays and supply chain impacts and a 10% decline in China, as expected, driven by the lower demand environment. Adjusted operating profit declined $24 million at actual FX and $19 million at constant currency as strong material productivity was more than offset by the impact of unfavorable regional and product mix.

Turning to Service segment results on slide 7. Maintenance portfolio units were up 4.2%, with recaptured units more than offsetting cancellations. This was the sixth consecutive quarter of accelerating portfolio growth, with China delivering another quarter of high-teens portfolio growth. Modernization orders grew nearly 30%, our third consecutive quarter of more than 10% growth driven by several major project wins, the continued success of our mod packages, and good momentum in proposal activity from improved sales coverage. Our modernization business continues to perform well across all regions, with backlog up 13% at constant currency.

Service organic sales of 6.3% was modestly ahead of expectations. Maintenance and repair grew 7% driven by solid repair volume, strong portfolio growth, and 3.5 points of maintenance pricing improvement on a like-for-like basis. Organic modernization sales were up 3.3% in the quarter driven by EMEA and Asia, partially offset by the timing of major project execution in the Americas. Service operating profit at constant currency was up $40 million and margins expanded 40 basis points. Drop through on higher volume, favorable pricing, and productivity more than offset the headwinds from annual wage increases and higher material cost.

Moving to slide 8 and the revised outlook. Overall, we are off to a solid start in 2023, delivering strong orders, sales and portfolio growth, while expanding Service margins to drive mid-single-digit EPS growth in the quarter, despite continued macroeconomic uncertainty. This strong start gives us confidence to reiterate our February outlook organic sales growth, adjusted operating profit at constant currency, and adjusted profit margins at both the Otis and the segment level.

We are improving our adjusted operating profit outlook by $20 million versus the prior guide, now expected to be up $90 million to $150 million from a smaller foreign exchange headwind. This FX change results in an approximately $0.03 increase in adjusted EPS at the midpoint.

Our free cash flow outlook remains unchanged at $1.5 billion to $1.55 billion for the full year. In the first quarter, free cash flow came in at $253 million, with working capital or use of cash of roughly $125 million largely due to payables. We expect this to unwind as we execute on our New Equipment backlog throughout the year.

Taking a further look at the organic sales outlook on slide 9. Our outlook remains consistent with the prior guide across all regions and segments, with New Equipment up 3% to 5% and Service up 5% to 7%, driving total Otis organic sales growth of 4% to 6% for the year. New Equipment organic sales growth will be driven by the Americas, APAC, and EMEA as we execute on the strong backlog built over the past few years. We still expect to achieve roughly flat New Equipment sales in China, given the quarter-ending backlog and favorable compares into year end. On the Service side, we expect to build on our performance in the first quarter, with growth and

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repair work moderating and modernization accelerating. Overall, we would expect to see consistent growth at around the midpoint of our guide each quarter.

Moving to our adjusted EPS outlook on slide 10, we now expect 7% to 10% growth, reflecting an approximately $0.03 increase from the prior guide at the midpoint. We anticipate second quarter EPS to be flattish year-over-year as strong operational performance is offset by last year's lower tax rate. The continued strong growth in our Service segment, coupled with pricing and commodity tailwinds in New Equipment, will drive the acceleration in our second half EPS growth. For FX, we are now assuming full year rates of €1.06 and CNY 6.93 for the euro and CNY, respectively.

Overall, we are encouraged by our first quarter results and well-positioned to deliver solid financial performance for the balance of the year by executing on our New Equipment backlog, accelerating our Service portfolio growth, and focusing on operational execution to offset macro headwinds.

With that, Didi, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from Jeffery Sprague of Vertical Research Partners.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Thank you. Good morning, everyone. Hey, just a couple quick ones here from me. First, just on mods. Interestingly, Schindler pointed to soft mods this last week and you and KONE are saying they're strong. Always thought of it a little bit more of a discretionary aspect to kind of mod work. So, maybe you could just give a little bit of color on what's – is there anything in particular driving the strength there, your visibility beyond kind of the current orders you've booked? And is there sort of a kind of pent-up demand to catch up on mods still from the delays we had back in COVID?

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

A

Hey, Jeff. Good morning. It's Judy. Listen, the mod business itself, I think you're going to see sustained and accelerating opportunities. It comes from, macro, 7 million of the 20 million units are 20 years or older in the world. It comes slightly from things that didn't happen during COVID, which you called pent-up demand. But it's really now coming from a realization that elevators are aging. Repairs – as you've seen, we've had a really strong repair book. So, people have been putting off modernization, and now they're coming to those important decisions. So, at the macro level, globally, we saw mod up in all four regions; strong order book this quarter, 29%; backlog up 13%. I think you can – you're going to continue to see that, not just quarter-over-quarter but year-over-year as the mod opportunity becomes larger.

At a micro level, I'll just share a short story with you, because part of mod is discretionary but part of it is a rational decision our customers are making. I'll give you an example in North America where we have almost 25-year-old two to six story hydraulic units installed throughout the country. We have a circuit board there where the parts had become end-of-life and obsolete. So, we went out to all out of our customers, because so many of these customers they only have one unit and they can't afford for it to shut down and not have access to an obsolete

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part. So, for our customers, we went out with digital marketing campaign and just said, listen, for a few hours we'll pre-plan, pre-schedule this, turnkey, one fixed price, let us come and make sure you avoid any shutdown and extend the life of your elevator. Response has been fantastic. So, part of mod is aging, part of it is opportunity creation, but you're going to see it continue to pick up over time.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great. And just on the growth in Service units, great to see, and you're kind of checking the box there on the strategic plan, it sounds like. I just missed, unless you didn't say it, the growth in service and maintenance units in China specifically and any other just kind of regional color that you might have on that.

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

A

Yeah, we had growth across the board. So, all four regions grew. China had its seventh straight quarter, they grew high teens, but seventh straight quarter of mid- or high-teens growth. So, Asia Pac and China up more significantly than the mature markets, which we would say is probably low-single.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great. Thank you. Appreciate it.

Operator: Thank you. One moment for our next question. And our next question comes from Steve Tusa of Morgan Stanley (sic) [JPMorgan] (00:20:15). Mr. Tusa, your line is open.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Yeah, sorry. Yeah, wrong Morgan, but maybe someday. Who knows? So, can you guys maybe just talk about how you're looking at the China market now? And maybe just the sequential trends on earnings into the second half of the year and anything moving around at all on your guys?

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

A

Yeah, thanks, Steve, and we fully recognize JPMorgan. So, let me be clear there. So, Steve, I had the – and I'm going to say honor of finally being on the ground again in China. So, what I'm going to share is a little personal, having spent ten days there earlier – late last month, early this month, and just really getting a sense of the economy. And I can tell you, you can feel it in the four cities I was in with our colleagues. It's in a state of recovery and, in my view, is primed for economic development.

No matter whether it was a government official I met with or customers, we do believe this second half recovery will come and will come strongly. The government's being very supportive in their policies, whether it's mortgage rates or other things. So, kind of where we started the year is what we're still seeing. We thought the market would be down 10%. We were down 3% in orders, so clear market share gain by Sally and the team in China.

But the strengths in the market in the first quarter, just so you know the segments, infrastructure and industrials were up – industrial buildings. There was weakness in resi and the commercial market, but we are still expecting the market recovery. And I'm feeling good about the health of our business. To be able to see the progress our

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team has made throughout the COVID years, whether it's in the automation in Industry 4.0 in our factories, the acceptance by our customers of our new product introductions, the relationships, I got to meet our agents and distributors. I'm very positive on the China recovery in the second half. Obviously, we want to see what the second quarter holds and when that inflection point is going to happen, but all signals look positive for China recovery second half. And then, obviously, that continuing into the out years.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

And then, just does that change at all, I guess, I missed the first part of the call, but any of the market outlook you gave on the fourth quarter call, any of those change?

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.
A

Yeah. So, as we shared last quarter, we said China would be down 10% the market, Americas would be flattish. We're seeing Asia Pac continuing to grow more to a high-single-digit and we think that offsets maybe a little more negative now with EMEA down low- to mid-single-digit.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Okay. Great. Thanks a lot.

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.
A

And, Anurag, I'll let you answer the second part.

Anurag Maheshwari
Executive Vice President & Chief Financial Officer, Otis Worldwide Corp.
A

Yes. Hey, good morning, Steve. Just on the sequential earnings into the second half of the year. So, second half, we have to grow EPS up to about $0.25. $0.05 of that will come from tax because we do face a headwind of $0.05 in quarter two because we had a big benefit in quarter two of last year. That unwinds in the second half of the year. So, that will give us $0.05.

So, the $0.20 we have to grow is about $120 million operationally. We are growing Service at about, in first quarter, $40 million. So, that run rate kind of continues into the second half of the year at a mid-single-digit growth. So, that's about $80 million. And the remaining $40 million will come from New Equipment. In the second half – I mean, quarter one New Equipment was kind of flattish, quarter two is returning back to growth.

In the second half, we expect mid-single-digit growth, about 5%, 6% on the New Equipment side. But volume and some of the price increases that we booked last year will flow through to the bottom line about $20-ish million from there. Commodity tailwind of $20 million in the second half. So, you add that up, New Equipment should be up $40 million. So, that's our sequential roadmap. About $80 million from Service, $40 million from New Equipment.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

Great. Great details as always. Thanks, guys.

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Anurag Maheshwari
Executive Vice President & Chief Financial Officer, Otis Worldwide Corp.
A

Thanks.

Operator: Thank you. One moment for our next question. And our next question comes from Nigel Coe of Wolfe Research.

Nigel Coe
Analyst, Wolfe Research LLC
Q

Correct. Good morning.

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.
A

Hi, Nigel.

Nigel Coe
Analyst, Wolfe Research LLC
Q

So, obviously nice job on orders. The Americas was surprisingly strong and, obviously, some of your competitors have been highlighting weakness in the Americas. So, maybe just talk about kind of what drove the growth and what you're seeing right now in multi-family and maybe commercial.

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.
A

Yeah. So, kudos to Jim and the team. I mean, the Americas, after a really strong 2022, to come in up 15% this quarter and rolling 12 months being strong as well, over 18%, just really highlights we've got a big backlog to work off in the Americas and our team knows it. Listen, we saw the Americas itself, the year is playing out as we thought it would. Non-resi is actually better this first quarter, infrastructure and commercial were up, and multi-family was down coming off some really tough compares if you think about where multi-family has been the past few years.

I will tell you, Nigel, that we got a real tough compare in the Americas coming up in the second quarter because last year's second quarter, we were up 54% in the Americas. So, we're going to do the best we can to try to match that but it's going to be a tough compare. We still expect a flattish market through year end. We think we're in a really good position. You saw the Montréal program we won, which was a major project in the first quarter, and that will take us a few years to perform on. But both the volume business and the major projects did really well in the Americas, both Latin and North America for the first quarter.

Nigel Coe
Analyst, Wolfe Research LLC
Q

Yeah, great. That's great color. Thanks, Judy. And then, turning to China. Your comments on China sounded really constructive. Pricing down low-single-digits. So, I think it was trending pretty flat through to 2022. So, just what gives you confidence that we're not going to see the [ph] bottom fall out (00:26:48) pricing in China? And then, when you talk about the inflection second half of the year, are we talking about a break back into positive year-to-year growth in orders or are we talking about getting [ph] less bad (00:26:58) in the second half?

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Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

A

Well, let me take the pricing question. We are seeing rational pricing. I know we've shared that about 90% of the New Equipment orders that happen in China now happen with the top 10 OEMs, and they're all being rational and we get to see that especially on public infrastructure bids. So, not to say there's not a bid or two someone really wants because of density and they'll do something, but we're seeing rational pricing in China.

It's always the most competitive there in pricing of anywhere in the world, and which means we've got to continue to drive our costs down. And that's where, so far, we've seen the material productivity far better in China than we have everywhere else in the world. Part of that's commodities coming down but part of that's through great supply chain management, negotiation, and our engineering team continuing to take costs down with our manufacturing team. So, we're seeing rational. We don't anticipate that changing, but obviously we're keeping an eye on it.

Anurag Maheshwari
Executive Vice President & Chief Financial Officer, Otis Worldwide Corp.

A

Yeah, and I mean, the two levers, as Judy mentioned, that we take a look at is definitely price/cost and the share of segment. So far, we're balancing it quite well. The market is disciplined and we continue to look into that, and make sure that that is the toggle that we are playing against. Now in terms of orders, if you look at the market, the market was down in the first quarter. We are guiding it to be down 5% to 10% for the year. So, clearly, the market is going to pick up from – in the second half of the year off a low compare as well from last year. And even if the market – we don't – as you know, share growth in the second half of the year, you should see orders in China picking up in the second half of the year. But of course, we're going to continue basically the strategy that we are doing right now and feel pretty good about the China orders in the second half of the year.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. Leave it there. Thanks, guys.

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

A

Yeah. Nigel, the only thing I'll add is our relationships and our length of those relationships with our 2,200 agents and distributors continues to mature, and we do expect those to yield as we continue to go on for both our brands. We're going to continue to ensure that we have the best products. We introduced a new product in China, a new [ph] roped (00:29:19) connected product in the first quarter, that's picking up nicely in the market. So, our team, they've got sales coverage. We know where we need to be on price. We've got the right products. And all that, we really expect to happen in the second half to show those results.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. Thank you.

Operator: Thank you. One moment for our next question. And our next question comes from Julian Mitchell of Barclays.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

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Hi, good morning. Just wanted to start with the EMEA market outlook. So, yes, you and some of your peers sort of lowering the market outlook this year. Just wondered, any specific verticals or regions within Europe that's driving that on the New Equipment side? How should we think about those EMEA orders playing out over the balance of this year? And I suppose the last time we had a sort of a soft construction market there for any prolonged period, we saw the bleed through into Service pricing at some point. Just maybe remind us kind of your confidence this time or even with a softer New Equipment market there that the Service price should hold up.

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

A

Thanks, Julian. So, yeah, we're saying EMEA now is going to be down low- to mid-single-digit. Obviously, we're watching rates and impact on building permits and starts. But in the first quarter, our team in Southern Europe performed incredibly well. Spain, Italy, extremely resilient. Where we saw some of the weakness was really Germany and the UK. And then, the Middle East was up, probably low-single-digits. So, it's really a mix and we're going to continue to monitor and watch that.

When we think back in time, I look at two key metrics. One is pricing, and Service pricing like-for-like this last quarter, we were up 3.5 points; and our Europe business was up mid-single-digits. So, Bernardo and team have been passing price through. We've had those inflationary clauses in, and the team's been passing Service price through, which is really good to see because the majority of our European contracts do come due – Service contracts come due in the first half of the year with most in the first quarter.

The other part would be all the constructors from 15 years ago who moved into service and became independent service providers, we don't see that labor. If you look at – even unemployment is at fairly low levels in Spain and in other locations in Western Europe. So, we don't see those – that available workforce starting up as independent service providers.

And the other difference now is what we call Otis ONE and the fact that when you have a connected elevator, it's not easy to start up as an independent right now or to grow your share. So, I think all that combines to set us up to a very different Europe. But again, we think we're being responsible looking at the market at low- to mid-single, potentially down for the year.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thank you. And then, just my follow-up would be around the slide 10. You've got that helpful EPS bridge. So, just if I look at the operational portion within that, you highlight there kind of wage and material inflation, and then mix and churn as headwinds that were not there on the bridge that you'd given back in January for the year ahead. So, just wondered if that's just an extra detail. Did you see something change in your outlook for those two items for 2023 and how we're thinking about those two items as you go through the year?

Anurag Maheshwari
Executive Vice President & Chief Financial Officer, Otis Worldwide Corp.

A

Hey, Julian. Hey, thanks for the question. When – in February, when we give guidance, we had a page on each of the segments, New Equipment and Service. And at that point in time, we had highlighted mix and churn as one of the headwinds. And then, we just collapsed it into the chart right now. There's been no change in our thinking since the beginning of the year.

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When we talk about mix and churn, we essentially – in the New Equipment side, the mix was coming from, as you know, China is our most profitable New Equipment margin market. So, there – and the other markets are growing faster. So, New Equipment side, that is the mix on – from the regional perspective. And obviously, we built a very good backlog, we won a lot of share, but it's a combination of volume and major projects. And these major projects, though they come in a very good portfolio stickiness, they are low New Equipment margin.

So, on the mix side, I would say, on New Equipment it's more region and project, similar to what we had called out in the last call. Nothing has changed from there. In Service, it's the same things you've seen in the past couple of years; China growing faster and, obviously, churn is more around the cancellation units which come with a little bit higher margin. So, nothing really changed over there. Same thing for labor and wage inflation, right. It's – so far, our labor negotiations are trending really, really well. We thought it would be low- to mid-single-digit in most of the European markets, it's playing out that way. And same on the material.

So, if I kind of take a step back, if you look at price over gross cost and mix and churn, we should be about $75 million positive for the year. That is – that would contribute to half of the operating profit that you see in the bar. So, price minus gross cost of material labor inflation and adjusting for mix and churn.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

That's really helpful. Thank you.

Operator: Thank you. One moment for our next question. And our next question comes from Jack Ayers of Cowen.

Jack Ayers
Analyst, Cowen & Co. LLC

Q

Hi, guys. Good morning. This is Jack on for Gautam. I wanted to dig into Service. And apologies, I joined the call fairly late here. But if you could kind of just touch on the modernization orders up 29% seems extremely strong, which is encouraging. And then, just piggybacking off that last comment just to – sort of the maintenance units up 4.2%. Obviously, really strong again. Kind of just what's happening there this quarter from like a retention conversion mix sort of churn perspective? Just any color there around Service would be really helpful. Thanks.

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

A

Hey, Jack. Yeah, modernization, let me just reinforce what I said, which is, it's going to continue to be a contributor to our business and the market itself is going to continue to grow not just quarter-over-quarter, but the market itself will be growing year-over-year as more and more units age based on when they were put into service. We've got 7 million of the 20 million units are over 20 years old. So, I think you can look for the modernization market to remain and actually become more attractive. And obviously, we're very focused on performing that in a more – a way that allows us to approach customers with [ph] kits (00:37:10). That gives us productivity and that gives them their modernization in a quicker time period.

So, you're going to see modernization be talked about more, but also take the best of what we've learned since spin in terms of our New Equipment strategy and growing share there and being able to do things at scale, merging that with our Service excellence and our productivity we've gained there. And when we put those two together and attack the mod market with a growing market, we think that's going to be a positive contributor for many – for much time to come.

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Jack Ayers
Analyst, Cowen & Co. LLC

Q

Thanks, Judy. I'll leave it there. Thanks, guys.

Operator: Thank you. [Operator Instructions] One moment for our next question. And our next question comes from Nick Housden of RBC.

Nick Housden
Analyst, RBC Capital Markets

Q

Yes. Hi, everyone. Thanks for taking the questions. I think you mentioned maintenance pricing was at about 3.5% like-for-like. I'm just wondering if that rate should accelerate as we move through the year just on the basis that you've been implementing the Service escalation clauses in Q1, and maybe that 3.5% is a reflection of the agreements that you had last year. So, if you could provide some color on that, that would be helpful.

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

A

Yeah, Nick – go ahead, go ahead.

Anurag Maheshwari
Executive Vice President & Chief Financial Officer, Otis Worldwide Corp.

A

Yeah. Hey, thanks for the question, Nick. Yeah, first, we're extremely encouraged with the way we started off in quarter one on 3.5% like-to-like. As Judy mentioned, Europe is mid-single-digits. It's probably one of the higher price increases we've seen in Europe for a while and it's sticking because everyone else is kind of driving the price over there. If you move into Q2, obviously, more units get converted, come up for renegotiation as well. So, we should see that kind of stepping up a little bit as we go there on the 3.5%.

So, overall, what we said in – when we gave the full year guide was that we expect it to be up 3.5%, 4%. Mix and churn would take about 200 to 250 basis points. So, about 1.5% net. We – as of now, where we stand, we feel pretty good about 150 basis points of pricing, adjusting for mix and churn for the rest of the year.

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

A

And, Nick, in China the margin drivers are less about price. They're really more about productivity, volume, density, and Otis ONE; and all of those are good contributors for us.

Nick Housden
Analyst, RBC Capital Markets

Q

Great. That's very helpful. Then my second question, sticking with Service. Great to see that you're up to 4.2% unit growth. So, that's been accelerating pretty much for three years at this point. You mentioned that the market is growing at about 5%, about 1 million units on a 20 million installed base. So, if I look at that 4.2%, you could still argue that that's maybe slightly underperforming. Do you think that you can actually close that gap or is that maybe a mix effect that means that you as the largest OEM in terms of Service units should maybe be underperforming a bit?

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Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

A

I think we can and we should close that gap. I just – that's the challenge we've given to our team; and that's why you see the much higher growth rates in Asia, especially China, for our Service portfolio. Now, it creates a mix but we will – we'll deal with that mix challenge as we get it. But yeah, we can and should be closing that gap.

Anurag Maheshwari
Executive Vice President & Chief Financial Officer, Otis Worldwide Corp.

A

Yeah. And just to add to that, right, I mean, just not too long ago, we were growing at 1%. The team is kind of – there was a call for action, teams focused on it. The winds have started churning. We're last year 4.1%, up 4.2%. We should close the gap. And the gap is – we've won some good New Equipment share, that will get covert – that will come into the conversion cycle. Our convention rates are going up, and we're going to keep looking at the – deploying IoT to ensure that our retention rates stay high.

So, it's using conversion as a lever, using retention as a lever to get us up to the mid-single-digit growth. And while doing that, we want to ensure that we also maintain the profitability for it, right? So, at some point in time, this – you will see from margins, it does come back to absolute profit growth, but that's where we went to take it to.

Nick Housden
Analyst, RBC Capital Markets

Q

That's great. Thank you very much.

Operator: Thank you. I would now like to turn the conference back to Judy Marks for closing remarks.

Judith F. Marks
Chair, Chief Executive Officer & President, Otis Worldwide Corp.

Thank you, Didi. And thank you all for joining us. And let me also add a thanks to all of our colleagues for your continued excellent performance in quarter one and for serving our customers so well. Our solid first quarter results demonstrate the continued power of our business model and set us up well for the future. We will remain focused on executing throughout the remainder of the year in order to capitalize on our first quarter successes and continue to drive shareholder value. Thank you for joining us, everyone. Stay safe and well.

Operator: This concludes today's conference call. Thank you for participating and you may now disconnect.

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