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Otis Worldwide Corp. (OTIS)

Q3 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Otis Third 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 would now like to turn the conference over to Michael Rednor, Senior Director of Investor Relations. Please go ahead.

Michael Rednor

Senior Director-Investor Relations, Otis Worldwide Corp.

Thank you, Michelle. Welcome to Otis' Third 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 nonrecurring 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.

Now 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 you, everyone, for joining us. We hope that everyone listening is safe and well. Starting with Q3 highlights on slide 3. Otis achieved strong results in the third quarter, marking 9 months of solid execution in 2023.

We grew organic sales 5.2%, with growth in both segments, expanded operating profit margin 60 basis points and achieved 19% adjusted EPS growth. This marks the 11th consecutive quarter of Service organic sales growth and the 15th quarter where our Service operating profit margin has expanded, demonstrating the consistency in our execution and the strength of our strategy.

With our fourth consecutive quarter of maintenance portfolio growth above 4% and backlog growth in both New Equipment and modernization, we have set ourselves up nicely for the future.

Last quarter, we announced the launch of our Gen 3 core elevator in North America. And in the third quarter, we sold our first units. This new product addresses the needs of our customers in the 2- to 6-story building segment.

The largest by volume in North America. We also continue to drive progress toward our ESG commitments. For the second year in a row, we achieved a gold rating from EcoVadis ranking us within the top 5% of all assessed companies.

We're also proud to have been named by Newsweek as one of the world's most trustworthy companies and one of America's Greenest companies. Let me share a few customer highlights from the third quarter. In British Columbia, Otis is providing 7 SkyRise and 8 Gen3 Edge elevators for South yards, a mixed-use development by Anthem properties.

South yards will include more than 2,500 residential units and over 60,000 square feet of retail and office space surrounding a 1-acre community park. In Hong Kong SAR, we're supplying 47 Gen 3 units to enhance access to more than 30 elevated walkways.

These elevators will provide improved accessibility for the aging population and people with disabilities, a key part of Hong Kong's universal accessibilities initiative. Construction is expected to be complete in July of 2026.

In Saudi Arabia, we secured a contract to modernize 18 elevators at the Saudi National Bank headquarters in Riyadh. As part of the modernization, we'll upgrade the controllers in the high-rise units while adding our Otis ONE IoT solution.

This new project builds on our existing relationship with the Saudi National Bank headquarters, which has 47 Otis units in total. And in China, we received a contract to maintain 351 units at Shanghai's Pudong Airport with 271 of these returning to the Otis portfolio as a recapture.

Pudong Airport is a critical cargo access point in East Asia, while also serving roughly 80 million passengers each year. We're proud to say we now maintain all Otis units to the airport.

We announced our UpLift program last quarter, and in Q3, we began executing initiatives focused on 3 essential areas: gaining scale across our global organization to unlock synergies, standardizing our processes to generate efficiencies, and driving supplier and indirect spend optimization.

We are on track to meet our stated expected run rate savings of \$150 million by midyear 2025. Taken together, these initiatives drive further value for our customers, organizational effectiveness and sustainable profitable growth.

Moving to slide 4. Q3 results and 2023 outlook. Organic sales in the quarter grew 5.2%, Service was up 8.4%, with all lines of business contributing and New Equipment up 1% with growth in the Americas, EMEA and Asia Pacific.

Although New Equipment orders declined 10% versus the prior year, backlog was up at 2% at constant currency. Our share in the quarter remained relatively flat, leaving us at approximately 50 basis points of share gain year-to-date.

Order growth in EMEA and Asia Pacific was more than offset by declines in the Americas and China. In Service, modernization orders remained strong, up 13% in Q3, the fifth consecutive quarter of mod orders growth above 10%, driven by strong performance in EMEA, China and Asia Pacific.

Mod backlog was up 15%, giving us line of sight to sales over the next several quarters. With adjusted operating profit growth of \$47 million in the quarter, we expanded margins by 60 basis points driven by 90 basis points of Service adjusted operating profit margin expansion.

We generated \$272 million of free cash flow, driven by higher net income. To summarize, we executed our strategy, growing the portfolio above 4%, increasing our New Equipment and mod backlogs, giving us a strong base to execute on for the next several quarters.

While expanding operating profit margins as we drive a consistent operating cadence in the business, ultimately leading to just under 20% EPS growth. Ultimately, we believe we're set up well despite the relatively weaker macro picture we're facing, which I'll discuss next.

For global New Equipment unit bookings, Asia Pacific continues to grow, although we now expect it to be up low to mid-single digits, a step down from our prior expectations. We anticipate that EMEA will decline high single digits, in line with our expectations for last quarter.

While Americas, we now expect to decline mid-teens and China to decline north of 10%, both worse than we were anticipating just a few months ago as the macro environment remains challenging.

In total, this would leave global New Equipment bookings somewhere around 850,000 units, down approximately 10% versus 2022. In Service, although global New Equipment unit bookings are smaller than we anticipated we still expect the Service installed base to grow nearly 5% this year as units that were booked 2 to 3 years ago and installed 1 to 2 years ago roll off their warranty periods.

This will put the global Service installed base somewhere between 21 million to 22 million units by year-end, of which we currently maintain approximately \$2.2 million and expect to end the year around 2.3 million units in our maintenance portfolio.

With that as the global backdrop, let me now update you on Otis' financial outlook. We expect organic sales growth of approximately 5.5%, with net sales of about \$14.1 billion.

Adjusted operating profit is expected to be approximately \$2.265 billion, up \$170 million at constant currency. At actual currency, adjusted operating profit is expected to be up \$140 million, including a foreign exchange headwind of \$30 million.

We're raising our outlook for adjusted EPS now expected to be \$3.52, up 11% versus the prior year. We now expect free cash flow of about \$1.5 billion or approximately 105% conversion of GAAP net income. We still expect share repurchases of \$800 million.

With that, I'll turn it over to Anurag to walk through our Q3 results in more detail.

Anurag Maheshwari

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

Thank you, Judy, and good morning, everyone. Starting with third quarter results on slide 5. Net sales of \$3.5 billion grew 5.4% and organic sales are up 5.2%, with growth in both segments. Adjusted operating profit was up \$52 million at actual FX and \$47 million at constant currency with margins expanding 60 basis points to 16.9%.

Drop-through on Service volume, productivity and pricing in both segments and commodity tailwinds were partially offset by inflationary pressures, including annual wage increases and higher corporate costs.

Adjusted EPS increased 19% or \$0.15 with over half of this improvement coming from strong operational performance and the rest from a combination of our capital allocation initiatives and ongoing effort to reduce the tax rate, which came in at 25.5% in the quarter.

Free cash flow came in at \$272 million, up \$57 million versus prior year, largely driven by higher net income. Year-to-date, we generated \$934 million of free cash flow \$81 million lower versus the prior year, driven by lower down payments on fewer New Equipment orders and the continued outperformance of our repair business as this work tends to be paid in arrears.

Moving to slide 6. Let me start by giving some color on Q3 New Equipment orders and backlog. In the third quarter at constant currency, New Equipment orders declined 10% versus prior year. Despite this, our New Equipment backlog increased 2%, with mid-teens growth in Asia Pacific, mid-single-digit growth in the Americas and EMEA roughly flat.

China backlog is down low single-digits. Sequentially outside of China, our New Equipment backlog was relatively stable in all regions. Globally, pricing on New Equipment orders was up low single-digits, building on a similar increase in the third quarter of the prior year. Excluding China, pricing improved by mid-single-digits or better in all regions. Although pricing was down mid-single digits in China due to macro challenges, we remain price cost neutral in the region from our continued focus on driving material productivity.

New Equipment organic sales were up 1% in the quarter, with strong growth in all regions outside of China. Asia Pacific grew low teens driven by continued performance in India as well as traction with major projects. In EMEA, New Equipment sales grew high single digits, underpinned by the significant orders over the past several quarters in Southern Europe and the Middle East, while in the Americas [ph] the region (00:12:16) grew high single digits for the second consecutive quarter executing on its multibillion-dollar backlog. We grew New Equipment operating profit by \$10 million at constant currency despite China sales coming in weaker than expected. Driving productivity, pricing flow through from the backlog and tailwinds from commodities more than offset the project in regional mix headwinds, leading to a 7.2% margin in the quarter.

Turning to Service segment results on slide 7. Maintenance units were up 4.2% with growth in all regions, led by high teens growth in China for the fourth quarter in a row. We delivered another strong quarter of modernization orders, up 13%, including China mod orders growing double digits from continued success of new product offerings. Asia Pacific also grew double digits due to a number of volume and major project wins, with standout performance coming from North Asia. EMEA mod orders grew 10% driven by major project wins.

At quarter end, our mod backlog was up 15%, with growth in all regions. Service revenue came in better than expected with all lines of business contributing to organic sales growth of 8.4%. Maintenance and repair was up 8.6% from higher-than-anticipated repair volumes, and mod was up 7.6% with growth across all regions, highlighted by double-digit increase in Asia.

Service pricing, excluding mix and churn, came in around four points, similar to last quarter's performance, and adjusted for mix and churn, was a net two points. Higher volume, favorable pricing and productivity were partially offset by annual wage increases and higher material costs, leading to \$53 million of Service profit growth at constant currency.

Service adjusted operating profit margin expanded 90 basis points in the quarter to 24.8%. Overall, we are pleased with our results in the quarter as well as year-to-date. We've grown our New Equipment and mod backlogs, expanded the portfolio at 4% and delivered over 10% EPS growth.

Moving to slide 8 and the revised outlook. Starting with sales. Total Otis organic sales are expected to be up approximately 5.5%, consistent with the midpoint of our prior guide, including slight adjustments by segment. Adjusted operating profit growth at constant currency is expected to be \$170 million, a \$5 million increase versus the prior guide's midpoint and the result of strong performance in the Service segment. At actual currency, we expect adjusted operating profit of \$2.265 billion as the better operating performance is offset by a slightly higher foreign exchange headwind and driven by a change in the euro and the weakening of various Asian currencies, such as the CNY.

Our margin expectations remain unchanged, with Service margins expected to expand 50 basis points to 24%, New Equipment margins expected to expand 20 basis points to just under 7%. This puts overall operating margins at approximately 16%, up 30 basis points. We have raised our guidance for adjusted EPS, now expected to be up 11% versus the prior guide, to \$3.52. This represents a \$0.04 increase versus the prior guide's midpoint, largely driven by strong operational performance and improvements in below-the-line items, including tax, now expected to end the year at 26%.

We expect to generate approximately \$1.5 billion in free cash flow, a roughly 105% conversion rate, and return substantially all of it to shareholders through \$1.35 billion of dividends and share repurchases.

Taking a further look at the organic sales outlook on slide 9. We now expect New Equipment organic sales growth of approximately 3% at the low end of the prior range, driven by larger-than-expected headwinds in China, which we expect to be down mid-single digits. The Americas and EMEA are still expected to grow mid-single digits organically.

In Service, organic sales are expected to be up approximately 7.5%, a 1 point increase versus the midpoint of the prior guide, driven by maintenance and repair. Consistent maintenance portfolio growth and pricing, together with another quarter of strong repair volume enabled us to raise the outlook by 130 basis points to up 7.3% versus the prior guide. Modernization organic sales expectations remain unchanged, up 8% as we execute on our backlog, which was up 15% at quarter end.

Moving to slide 10. We have raised our expectations for adjusted EPS, and now anticipate growth of approximately 11% or \$3.52, a \$0.35 increase versus the prior year, driven by \$0.30 of operational improvement.

In closing, we continue to execute well on the things we can control, and our resilient Service business is driving profitable growth in an uncertain macro environment. Our strong year-to-date performance gives us confidence to again raise our EPS outlook and deliver a solid fourth quarter, while positioning us well to perform in 2024 and beyond.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] The first question comes from Jeffrey Sprague with Vertical Research Partners. Your line is open.

Jeffrey Todd Sprague

Analyst, Vertical Research Partners LLC

Q

Thank you. Good morning, everyone. Judy or Anurag, could you just elaborate a little bit more on your view on both Americas and China New Equipment, kind of the downward tick in the outlook, and maybe just thoughts on kind of even the trajectory as we exit 2023 into 2024 in those particular regions?

Judith F. Marks

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

A

Yeah. Happy to, Jeff. Let me start with the Americas. So we're now – we now believe the New Equipment market in the Americas is going to be down mid-teens, and we're really seeing that with the highest impact being the interest rates remaining high. It really is impacting new project starts. We've seen that in the most recent ABI and Dodge data. So we're watching that closely. I would tell you the residential performed the worst in the third quarter, followed by commercial not being great, and infrastructure for the quarter being relatively flat. We expect infrastructure to pick up as we go into 2024. We tend to see that a little later in the cycle versus the early construction companies, with all the infrastructure activity that's starting.

What I do like about the Americas beyond their performance, and they really had a strong performance in terms of backlog conversion, is we still have strong mid-single digit backlog on New Equipment. That puts us in a really good position, not just for the fourth quarter, but I would tell you with our cycle time in the Americas, it gives us really good line of sight for the next 12 to 18 months in – especially in North America, which is the majority of our Americas business.

So we'll wait and see what happens with interest rates. If this does become the new normal, we think people will adjust. Because housing demand is real. It's still there, so we have to wait and see where this equilibrium is going to come out with the developers and when they go ahead with projects.

We're not seeing a decline in terms of interest or proposals. So we really – at this point, it's about people having conviction to start the projects from a development perspective. In China, the New Equipment market does remain somewhat weak, and it's worse than we saw it a quarter ago, when we told you we didn't see that inflection point for book and ship. We're now saying it's really down. The China market itself is really down north

of 10%. So we are continuing to focus on our pivot in China. And I couldn't be more proud of our team in China in terms of what we've done on the maintenance side to offset this, as well as really how we've managed material productivity to be able to drive that cost price neutral scenario in China.

We have picked up share in China for the year. And so we will continue, even though the backlog is down, our team is continuing to fight for all units and execute our strategy, which has been in play, which is focusing on key accounts mainly state-owned enterprises, and continuing new product introduction and expansion on Otis ONE. So our mod is up in China for the fifth straight quarter – or sorry, for this year, it's up double digits. So far all year. We've had the ninth straight quarter in China on the Service side of mid to high single – high teens Service growth. So we're finding a nice place there in terms of this pivot to becoming more of a Service provider. But New Equipment is our highest margin in China. And I think what you see with the results is despite China being down, our other three regions really picked it up nicely for us to be able to hold margins at 7% on New Equipment for the quarter and to grow organically 1%, even with China down fairly significantly.

So we'll wait and see what happens in terms of stimulus. Obviously, we've seen certain actions already in China in terms of easing monetary support, postponing property taxes, loosening credit policy for mortgages, but we really do – are watching sentiment and liquidity. Those are the two items that we're watching.

Jeffrey Todd Sprague

Analyst, Vertical Research Partners LLC



Great. And just to shift completely in a different direction. You started the conversation, Judy, with UpLift kind of getting off the ground, I guess, no pun intended. But maybe just a little bit of color. Is it impacting results in Q3? How do you see kind of the staging of that \$150 million that you're talking about?

Judith F. Marks

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



Yeah, there is no impact in Q3. We just – early days for us. We've kicked off the key activities, including the operating model. A lot of education inside the company and a lot of focus now on process redesign and indirect spend. You'll see that start coming through slightly in Q4, but 2024 is when you'll really start seeing that impact, and then we'll achieve the run rate. We're very comfortable with all the analysis we've done, as well as some of the decisions we've taken already that the \$150 million is absolutely achievable.

Jeffrey Todd Sprague

Analyst, Vertical Research Partners LLC



Great. Thank you.

Operator: Please standby for our next question. The next question comes from Nigel Coe with Wolfe Research. Your line is open.

Nigel Coe

Analyst, Wolfe Research LLC



Thanks. Good morning, everyone. So I understand the kind of like the [ph] weakness, your updates (00:24:28) across the globe. Are we seen any product cancellations with the rising rates, some projects now cancelled out? So just wondering on that. And then – but maybe, I just want to dig in a bit more into China with the pricing down mid-single digits. I think that the view was that China would not kind of be as bad as perhaps prior down-cycles because margins there are much lower. So just curious how you see the risk of further deterioration in China. And

you mentioned price cost remaining positive or rather neutral in China, are China margins holding there? Or are we seeing some deterioration in margins?

Judith F. Marks

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

A

Yeah. Let me start, and then I'll have Anurag add. Nigel, we're not seeing project cancellations at any level different than we have in the past. And we can say that everywhere in the globe. There are always a small amount of project cancellations that occur, in which we retain the deposit, the advanced deposit, but nothing unusual there.

In terms of China, let me just make sure everyone understands that China now represents about 17% of our global revenue. Now there are several reasons for that. One is a down China market. But second is with us now outlooking \$14.1 billion in revenue and organic growth of 5.5%, you can see the impact and the pickup of the other three regions in terms of their growth. So nice call out, Americas, EMEA, Asia Pacific, really good revenue growth, as you saw in Anurag's presentation. But China is now about 17% of our total revenue, down from 20% traditionally. So that's just the reality of where the numbers are right now. On price cost, Anurag, why don't you comment?

Anurag Maheshwari

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

A

Yeah. So on price cost, as you mentioned, Nigel, we are either neutral or positive, right? In China, definitely pricing in the New Equipment side is coming down, but we are driving hard on material productivity. And it's a deflationary economy over there as well. So a combination of that and there's pricing discipline in the market, you put all of that together, right now price cost is favorable, and we are able to offset the China mix as you saw in third quarter, with the New Equipment margin being at 7.2%. And even if you look at the fourth quarter implied outlook, New Equipment margin is going to be about 7% even though China is going to be down.

So a couple of reasons. One is obviously, the price cost in China. Second, pricing in all the other markets that has gone up over the past 12, 15 months, which is in our backlog, it started flushing through to the P&L. We again saw this quarter another \$10 million pickup of pricing. We're going to see that similar in the next quarter, and commodity is a tailwind.

So if I look at pricing in the backlog overall, which is probably up 50 to 70 basis points, and if we snap the line on commodity today, right, we should still see another \$40 million or so tailwind next year. You add these two things together, I think it more than kind of makes up for the China mix for us to believe that our New Equipment is at a sustainable margin rate.

Nigel Coe

Analyst, Wolfe Research LLC

Q

Okay. Great. And I know there's about three questions in there. But if I can get one more as a follow-on. Just a follow on to Jeff's question on the UpLift program [indiscernible] (00:27:49) time. So obviously, the \$150 million run rate, I'm assuming that exit 2025 run rate. What would [ph] make you (00:27:56) feel comfortable in a down in FY 2024 in terms of cost savings? And what sort of restructuring would be associated with that savings?

Judith F. Marks

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

A

Well, we're not going to guide yet for 2024 UpLift savings, so we just need to be – yeah, we're not prepared to do that. We'll get back to you, obviously, when we do our 2024 guide to let you know what's going to be in that late January.

Anurag Maheshwari

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

A

Yeah.

Judith F. Marks

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

A

In terms of restructuring, [ph] I think we've been (00:28:24)...

Anurag Maheshwari

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

A

Exactly. So [ph] for us, (00:28:26) program is off to a great start, as Judy mentioned, we'll give an update next year. In terms of – to achieve the \$150 million of savings, the restructuring cost is about \$150 million. It's a one on one, right? It's going to start this quarter. But obviously, we're going to start seeing the savings coming in next year.

Nigel Coe

Analyst, Wolfe Research LLC

Q

That's great. Thank you very much.

Operator: Please standby for the next question. The next question comes from Julian Mitchell with Barclays. Your line is open.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Just wanted to start off with the global New Equipment revenue outlook. So you've been feeding off a good backlog there and the organic sales maybe flat to up 1% year-on-year in New Equipment in the back half of the current year. I just wondered though, when you look at the sort of 12 months rolling on New Equipment orders down 4%, year-to-date down 6%, last quarter down 10%, and then we think about sort of the nature of how quickly the backlog wears off. It's very fast in China, slower the rest of the world. Is it sort of base assumption as we start out next year that New Equipment sales are down then as those weaker orders feed through?

Anurag Maheshwari

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

A

Yeah. Thanks for the question, Julian. Yeah, so firstly, our backlog is up 2% on the New Equipment side. We do think that even if orders are down low to mid-single digit in the fourth quarter, our backlog is going to be flattish to slightly up. And the reason is because we tend to book more orders than revenue over the past couple of years, some of them in major projects. So our assumption is that backlog should be flattish to up by end of the year.

Now within that, Americas, Europe and Asia Pacific, if we put that together, that backlog is up low to mid-single digit, and that represents roughly about two-thirds of our New Equipment revenue. So that should be kind of up low to mid-single digit next year. Let's say, low single digit. The big variable, of course, is one-third of the revenue,

which is China. Right now, China backlog is down low single digit. It could be down mid-single digit by end of the year. And what happens to the market over there, it could be flattish, it could be down 10%, it could be up, right?

So that, we do not know as to where that's going to happen. But let's assume that the market goes down next year and then China is probably down 5%, so that would mean that our New Equipment revenue could be flattish. So – but if I put things in all perspective, it could be flattish, it could be up 2%, it could be down 2%. But 2% or 3% of New Equipment revenue is about a couple of hundred million dollar of revenue. And if we look at our margin, it's about \$14 million, \$15 million, \$18 million of profit, which is \$0.02 or \$0.03 of EPS.

If you look at what we did this year, we more than overcame that through the Service business, which is why we – and our guide went up every quarter because of [ph] lack of (00:31:34) Service. So we think we should be able to make that up next year through our Service business.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

That's very helpful. Thanks, Anurag. And maybe just my follow-up would be around the Service margins perhaps. So one element is if I just maybe some incorrect maths, but it looks like the Service margin in Q4 in the guide is down sequentially or flat sales and sort of flattish year-on-year, despite a big increase year-to-date. So just wanted to check if that's right and if it's just conservatism or what have you. And then secondly, on the Service margin, how are we thinking about sort of price cost or price net of material cost and Service wages playing out? Is that sort of getting larger into next year or narrowing as a tailwind, just any context around that, please?

Anurag Maheshwari

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

A

Absolutely. So I'll break it up into two separate questions over here. So first is, yes, the guide implies 24% margin for Service in the fourth quarter, which is sequentially down 80 basis points. But we're going to exit the year at what we guided for the full year, which is 24%. It's a very healthy margin rate. It's – from last year where we actually – it's a tough compare because last year, we grew margins by 60, 70 basis points in the same quarter. And the reason there's a difference between 24.8% and 24% is largely two things. It's the mix.

We – I mean, we are very encouraged. I mean the performance in third quarter margin was fantastic. I mean if you look at the portfolio maintenance side, portfolio is growing, pricing is sticking. We are flushing mod backlog into revenue. And the repair business, which we thought after years of very high growth is going to slow down, is not. And it's because of the strategy of the team of penetrating more of the portfolio, and that mix was high in the third quarter. And obviously, productivity, which helped us get to the 24.8%.

The big difference between Q3 and Q4 is now we're assuming that repair to be flattish in the fourth quarter and mod growing double-digit. So that is a mix impact which is leading for the margins to be lower. But net-net, we're exiting the year at what we guided, so feel pretty good about it on the Service side.

Judith F. Marks

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

A

Yes, Julian, on the second question, where you're talking about wages and inflation. Inflation on the Service side, while we have had wage inflation, we know we need to offset that with productivity. And what we've been doing with price has been fairly significant. We've had another quarter where our Service pricing like-for-like is up 4 points. And with inflation staying pretty high, especially in EMEA and in the Americas, we should be able to, as we

negotiate the majority of our maintenance contracts first, second quarter next year, which are mainly backward-looking for this year's inflation, we expect to be able to get price again at levels comparable to that for 2024.

We have line of sight now. The majority of our 23 maintenance contracts are in the books, as are our commodity prices and everything else as we go in – with 2.5 months left to go now. So we're actually feeling pretty good about Service pricing for next year and price cost. And we've negotiated with the majority of our collective bargaining across the globe. Most of our mechanics are represented. And I think I know we've treated them fairly, and we're able to recover that in both price and productivity.

Julian Mitchell

Analyst, Barclays Capital, Inc.



Great. Thank you.

Operator: Please stand-by for the next question. The next question comes from Joe O'Dea with Wells Fargo. Your line is open.

Joseph O'Dea

Analyst, Wells Fargo Securities LLC



Hi, good morning. Thanks for taking my questions. I wanted to circle back to the backlog comments, and could you just expand on how much of next 12 months revenue you generally have visibility into based on backlog levels. And talk about that in Americas and Europe, and then in China. And in particular, in China, then the mix that would be coming out of backlog and the mix would be book and ship, and what you're seeing in some of those book-and-ship trends recently.

Anurag Maheshwari

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



Yes. Absolutely. If you look at our backlog, it is significantly more than a 12-month revenue, because we got major projects in there, we have other kind of long-tail projects as well. We very specifically the reason why I said earlier, we have confidence of America and Europe kind of growing low single digit next year is – even if we snap the line today, we have very high visibility of that converting. We enter any particular year with 80%, 90% of Americas and EMEA revenue coming out of backlog. Followed by that is Asia Pacific, ex-China, which is probably a little bit lower depending upon the geography mix. But that backlog is up very healthy, it's probably double digit up, right?

Then China is the only one where we have higher book and ship. So when we enter the year, I would say two-thirds of that revenue probably comes from the backlog and a third comes from the book and ship, which is why for three of the four regions, we feel its low single-digit growth for next year. China is the only variable that we need to see how the next few months to go.

Joseph O'Dea

Analyst, Wells Fargo Securities LLC



Got it. That's helpful. And then just some perspective on where China volumes are? Can you talk about for the total market where volumes have been over the last several years, where they're trending this year? How you think its setting up in terms of next year for some perspective on the current softness relative to recent strength?

Judith F. Marks

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

A

Joe, we would tell you that if you go back to peak years in China, we probably peaked – the segment peaked New Equipment at about 650,000 units. That's been coming down now for the past two years, and we're at about 450,000 currently for this year. Still 450,000 of the 850,000 global units, so still a large, healthy market. And 450,000, you probably have to go back to 2018-ish timeframe to where we had, obviously, pre-COVID to having a market like this. And so we still think it's a very attractive market.

We've gained share there this year as we look in China, and we will continue to execute our strategies of our agents and distributors, being our partners, which we now have about 2,350 agents and distributors, more than twice since we spun. We focus on our key accounts. And we've also really focused on the tier cities that are having an impact.

So if you look at the third quarter, Tier 1 cities – Beijing, Shanghai had the best market segments. And then obviously, it trailed off as you got all the way to Tier 5. So we've adjusted our strategy. That's why our agents and distributors are so helpful, as well as our internal sales folks that support them. The key accounts, again, those relationships are strong and they're yielding for us.

Joseph O'Dea

Analyst, Wells Fargo Securities LLC

Q

Thank you. Appreciate the details.

Operator: Please standby for the next question. The next question comes from Stephen Tusa with JPMorgan. Your line is open.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Hey, good morning.

Anurag Maheshwari

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

A

Hey, good morning, Steve,

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

You mentioned the trends of what's going on in China. I think one of your competitors had some pretty good orders numbers there today. Can you maybe help reconcile that? Because I don't – I think you guys were obviously – I think you were down. But maybe you could just maybe help reconcile what the difference might be? Obviously, any quarter, there's some lumpiness. But just curious from a share perspective there, just trying to tie those two things together.

Judith F. Marks

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

A

Yeah. I think you're going to – I mean, orders are lumpy kind of across the board for both modernization and New Equipment. And I would argue, share is also kind of hard to measure on a quarterly basis and something more you'd like to do on an annual level when you really have some fidelity in the information. I can't comment on what

our competitors are doing, but I can tell you that we're – again, our China team is executing our strategy. In a downmarket, our China team has both driven cost out in terms of material productivity so that. Again, if you look at and you step back, we're driving growth in all lines of business in Otis, especially in Service.

We're seeing good growth in three regions outside of China. But our China team has really – and despite a tough macro environment on New Equipment, has really now added this Service component, which [indiscernible] (00:40:48) 365,000 units in our portfolio in China, more than double from when we spun. And our China modernization business has grown double-digits this year. So we're finding – we're moving mod into the factories. So we're optimizing the cost basis there, and you're going to see that modernization business really, in China as well as globally, take off.

And for us, we need to watch that mix. That's what Anurag commented on for fourth quarter for Service margins. But we think – we know it's actually worth getting that modernization business because it'll bring more units to our portfolio. So we're going to end this year at 2.3 million units in our portfolio. And when you think about 1% portfolio growth throughout the decade before – before we spun, and now it's five – four straight quarters over 4%, we're going to end this year at 2.3 million units, and that is the strongest. But it's still at 2.3 million units of a 21 million, 22 million segment, leaves us lots of room for growth. And that's why we're convinced the Service-driven growth strategy globally is the right answer for us and our shareholders.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Yes. Clearly, the Service is very strong. Just a question on cash flow. I missed the first part of the call, but any reason for that tweak on cash specifically?

Anurag Maheshwari

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

A

Yes, absolutely. It's – okay. So firstly, on cash, we are at about \$934 million, we got 550. And I guess your question is tweaking to the low end of the guidance, there's two reasons. One is clearly lower down payments because of New Equipment orders, which have been a little bit lower. But second is also our repair business, which has grown – we thought in this year would be low single-digit repair, it's growing at a very good rate. Great for sales, great for profit on the P&L side, but we do get paid after we complete our work. So it's a little bit of a receivable drag. I think it's a combination of these two reasons why you see a little bit of a tweak in the cash flow guide.

Judith F. Marks

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

A

Yes. And for any of our customers listening, Steve, I think it's important they know that when they need a repair, we do the repair. And then we make sure we bill and follow-up to collect. And that's really what happens in that repair world. We know customers if they've gotten an elevator down, we're going to get them back up.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Sorry. One last quick one. A lot of volatility in multifamily in the US, kind of hard to tell where that business is going. Any impact on you guys from that? And thanks a lot for the answers to the questions.

Judith F. Marks

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

A

Yes. So I mean that multifamily was our – from a market perspective, a segment perspective, was the worst performing in the US this past quarter. Now it's down off record highs for multiple years, and there's still demand for it, but we're just seeing the developers slowdown on the start button, which is when we get those advances that Anurag was talking about in his cash answer.

So we'll wait and see. If rates stay where they are, developer will figure out the math for this because demand is still there for housing. So we're in a wait and see. But our backlog in – especially in North America, is strong mid single-digit, including a lot of multifamily in the backlogs. So we're going to keep performing and then our team will drive the orders as they come.

C. Stephen Tusa

Analyst, JPMorgan Securities LLC

Q

Great. Thanks a lot.

Operator: Please standby for the next question. The next question comes from Nick Houston with RBC. Your line is open.

Nick Housden

Analyst, RBC Capital Markets

Q

Yes. Hi, Judith, Anurag, Mike. Thanks for the questions. So yes, just on that free cash flow point, I mean, it looks like China's never going to go back to that 650,000 unit mark. So I'm just wondering if that means that over the medium term there needs to be a permanent reset on the expectations for cash conversion from the current sort of 100% to 110% target that you've already got? That's the first one. Thanks.

Judith F. Marks

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

A

Well, I can take that one. The answer is no. No reset.

Nick Housden

Analyst, RBC Capital Markets

Q

Okay.

Anurag Maheshwari

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

A

There's no reset because the two – the new lower – definitely lower orders, but also we're executing on high backlog. So all these will normalize, and the repair revenue will also kind of – will start converting more into cash. So I don't think there's any reason for us to reset the target, yeah.

Nick Housden

Analyst, RBC Capital Markets

Q

Okay. Great. Very clear. Then just a second question on some of the competitive dynamics in modernization. So it sounds like when you guys or some of your European competitors modernize a unit, especially in China, it's almost always someone else's unit. And very often, it's one of the Asian competitors units that you're modernizing and then moving into your own portfolio. Have the Asian guys just not focused on modernization? Or why does it seem to be the case that you are kind of eating their lunch there?

Judith F. Marks

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

A

Well, your hypothesis that most of our modernization is on non-Otis equipment in China is accurate. But remember, our China market share is – our share of segment in Service is pretty low, because 75% of the – all the units in China are maintained by ISPs. So I wouldn't specifically say it's – some of the units we're getting back are Otis units that are not on portfolio, many are non-Otis units, but they're not necessarily Japanese or European.

I can't comment on who they are. But what we've done is we've created very innovative packages to be able to put our hardware on non-Otis equipment to modernize it, to add new technology and then to convert it into our portfolio.

Nick Housden

Analyst, RBC Capital Markets

Q

Okay. Great. Thank you.

Operator: [Operator Instructions] Our next question comes from Gautam Khanna with TD Cowen. Your line is open.

Gautam Khanna

Analyst, TD Cowen

Q

Hey, good morning guys.

Anurag Maheshwari

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

A

Hey, good morning, Gautam.

Judith F. Marks

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

A

Good morning.

Gautam Khanna

Analyst, TD Cowen

Q

I had two questions. First, Anurag, on your comment about escalators next year being comparable to that of this year. I was just wondering if you could elaborate maybe by region, and why that's so, given the level of inflation this year seems below that of last year? And then I have a follow-up.

Anurag Maheshwari

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

A

Yeah. Sorry. Gautam, you mean on the Service business, the price escalation?

Gautam Khanna

Analyst, TD Cowen

Q

Yes.

Anurag Maheshwari

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

A

Yes. So yes, listen, let's start with Europe where we got about half of our portfolio over there. Inflation is still pretty high in Europe. Not as high as last year, but not too far off from there. And most of our contracts are right now in negotiation, and they're obviously linked to an index. So we feel pretty good about the pricing increase in Europe next year could be around the mid-single-digit level again. So that's really encouraging.

Inflation in the Americas is also not coming down to a greater extent, so we should see that. So these two definitely give us confidence on pricing going up. The rest of Asia has always been a low to mid-single-digit price increase that will continue. And China, I think, as I mentioned earlier, there is more price discipline, but it's never been a price escalator market on the Service side. So put all of that together, it gives us confidence that there is going to be another good price increase next year on top of our portfolio growth, which should mean that our maintenance business should grow mid-single digit plus.

Gautam Khanna

Analyst, TD Cowen

Q

Okay. And just a quick follow-up. Could you talk a little bit about any trends in churn coming down in the quarter and maybe year-to-date on Service renewals?

Judith F. Marks

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

A

So we will share our statistics at our fourth quarter earnings. We do that on an annual basis, but there's no significant changes that we've seen, but we'll share that next quarter.

Gautam Khanna

Analyst, TD Cowen

Q

Thank you.

Operator: I show no further questions. At this time, I would now like to turn the call back to Judy Marks for closing remarks.

Judith F. Marks

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

Yeah. Thank you, Michelle. Our Service-driven business model is working as we approach 2.3 million units in our portfolio by year-end, with the compounding lifetime value of each additional unit. Year-to-date results are indicative of the strength of our strategy as we continue to prioritize value creation for our shareholders for the remainder of 2023 and beyond. Thank you for joining us today. And stay safe and well.

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

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