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Otis Worldwide Corp. (OTIS)

Q4 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Otis Fourth Quarter 2020 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 Stacy Laszewski, Vice President of FP&A and Investor Relations.

Stacy Laszewski

Vice President-Financial Planning and Analysis & Investor Relations, Otis Worldwide Corp.

Thank you, Justin. And good morning, everyone. Welcome to Otis's fourth quarter 2020 earnings conference call. On the call with me today are Judy Marks, President and Chief Executive Officer; and Rahul Ghai, Executive Vice President and Chief Financial Officer. Please note except where otherwise noted, the company will speak to results from continuing operations excluding restructuring and significant onetime nonrecurring items.

The company will also refer to adjusted results where adjustments were made as though Otis was a stand-alone company in the current period and prior year. The 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, upcoming annual report on Form 10-K, and quarterly reports on the 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.

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Judith F. Marks

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

Thank you, Stacy, and good morning, everyone. Thank you for joining us. And we hope that everyone listening is safe and well. I'm pleased we've delivered a strong quarter and a solid year. Despite the challenging environment, our 2020 results demonstrate the resiliency of our business and the benefits of becoming an independent Otis.

We grew adjusted earnings for the second year in a row, generated $1.3 billion of free cash flow, expanded our product and service offerings, and remained agile to support our customers as the pandemic evolved. We expanded adjusted margins by 70 basis points in 2020 following eight years by 70 basis points in 2020 following 8 years without margin expansion as a segment of UTC, demonstrating the benefits of our independence.

I could not be prouder of our 69,000 Otis colleagues who rose to the unique challenges presented throughout the year and never wavered in their commitment to provide essential services to our customers. And we did this while staying true to who we are, recognizing the challenges within our communities and allowing our Otis absolutes to keep each other safe and guide our actions and behaviors toward a more equitable future.

For the full-year, organic sales were down 2.1%. At constant currency, adjusted operating profit was up $52 million, a $17-million improvement from the midpoint of our prior outlook. Margin expanded 70 basis points, reflecting the strong performance in the Service segment throughout the year. Adjusted EPS was $2.52, up $0.28 or 12.5% versus the prior year and a $0.10 improvement from our prior outlook.

Now turning to page 4. In our New Equipment segment, we grew share by 60 basis points with growth in all major regions. We proudly mark the 20th anniversary of our Gen2 platform and hit a major milestone, surpassing more than 1 million Gen2 units delivered to date. We continue to innovate, introducing new solutions for customers. For example in India and other developing markets, we introduced the Gen2 Prime, a low cost entry level elevator.

And in China, we began shipping new equipment units enabled with our IoT platform, Otis ONE. This year, we'll expand this offering to include shipping IoT-enabled units in the US, Asia-Pacific and EMEA. And we continue to pilot GEN360, our next-generation digitally native elevator that brings the advantages of connectivity into a new more compact platform. We anticipate formally launching this transformational solution in the EMEA region later this year.

We enhanced our sales force's ability to address the market by increasing sales coverage mid-single digits, including adding more than 850 agents and distributors in China, and implemented tools to improve efficiency on the back end. Today, more than 85% of our business is on a common CRM system. And we continue to find new ways to reach customers in this dynamic and more digitally enabled environment.

Service is the core of our business. In 2020, we added to our industry-leading maintenance portfolio by approximately 2% with growth in all major regions including high single digit growth in China. This growing portfolio which accelerates our recurring revenue business model along with cost containment actions and productivity initiatives allowed us to grow earnings. This resulted in adjusted margin expansion in all four quarters and 110 basis points of expansion for the year.

I'm pleased with our progress made on the IoT deployment. We added approximately 100,000 Otis ONE units as planned, bringing us to approximately 540,000 connected units. Over the medium term, we plan to accelerate portfolio connectivity to approximately 60% of units, up from the roughly 25% currently connected, creating value for our customers and productivity benefits for Otis.

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This year, organic modernization sales were flat globally as we faced project delays in some regions due to COVID-19. However, modernization demand in Asia Pacific was particularly strong with orders up approximately 30% and sales up double-digits, driven largely by regulatory demand.

Our operational initiatives generated favorable outcomes. We're very focused on material and service productivity to offset headwinds from labor inflation and commodities. Approximately 70% of our Service cost base is labor and approximately 70% of our New Equipment cost base is material. We have material productivity initiatives to more than offset any potential impacts from raw materials. And in 2020, we achieved our goal of 3% material cost savings, helping to offset some of the volume headwind to New Equipment.

The early actions taken by our supply chain team, leveraging our scale, rationalizing spend and taking cost out of products provided the protection and assurance even during COVID that we would deliver on commitments made to customers. Our focus on cost containment extended to adjusted SG&A where we reduced expenses by $38 million versus the prior year while expanding our sales coverage.

As noted, we generated $1.3 billion in free cash flow with conversion of 143%, exceeding our prior outlook by $150 million. We channeled our strong cash generation into our capital allocation strategy, including bolt-on acquisitions to increase our scale and density, $350 million to repay debt ahead of our original schedule, and returned approximately $260 million to shareholders through dividends in the last three quarters of the year.

We made significant progress on our tax structure throughout the year, reducing our adjusted tax rate by 370 basis points versus the prior year and 260 basis points better than Investor Day expectations. We expect over the medium-term to bring our adjusted tax rate to a range of 25% to 28%.

And as a final comment to 2020 and amid promising news of vaccine approvals and distribution plans, the three-month study using scientific data and analysis on elevator airflow sponsored by Otis and led by a Purdue University professor and indoor air quality expert, concluded that elevators have significant air exchange by design and required by code. And a short elevator ride has a risk of exposure level less than that of outdoor dining.

Turning to slide 5, and starting with the industry's outlook. While market dynamics remain fluid, the industry's long-term fundamentals remain solid. We are encouraged by the pace of recovery and signs of wider availability of COVID-19 vaccines. The industry's New Equipment segment is expected to return to growth in all regions with mid-single digit growth in Asia, low-single digit growth in EMEA and slight growth in the Americas. The recovery in New Equipment will continue to feed the global install base and present future Service opportunities.

The core of our business is based on our Service model and the Service market itself is expected to grow about 1 million units per year globally industry-wide. Industry installed base in the Americas is expected to grow low-single digits. EMEA, where roughly 50% of the Otis maintenance portfolio sits, is expected to grow low-single digits. And in Asia, we're expecting mid-single-digit growth driven by China. At Otis, we are confident in the momentum we built in 2020 and our ability to execute on our long-term strategy.

Looking specifically at our 2021 Otis outlook. For the year, we expect sales growth of 4.5% to 6.5% with organic sales growth of 2% to 4%. Adjusted operating profit is expected to be up $125 million to $175 million. And adjusted EPS is expected in a range of $2.67 to $2.77, up 6% to 10% versus prior year and $0.20 at the midpoint.

Lastly, we expect free cash flow to be robust in a range of $1.3 billion to $1.4 billion with conversion of approximately 120% of GAAP net income. We will remain disciplined in our capital deployment and are well-

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positioned to start share repurchases following $150 million of debt repayment that was already completed in January.

The foundation we built this year as an independent company, along with the expected recovery in our end markets, gives us confidence that our strategy is working for our customers and shareholders. Our operating leverage, our global footprint, our successful innovation program, our capital management and strong balance sheet, and our industry-leading colleagues give me full confidence we can deliver on our outlook this year and many years beyond.

With that, I'll turn it over to Rahul to walk through our results and 2021 outlook in more detail.

Rahul Ghai

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

Thank you, Judy, and good morning, everyone. Starting with fourth quarter results on slide 6. Net sales returned to growth in the quarter and were up 4.2% to $3.5 billion. Organic sales were up 1.3%, driven by a strong recovery in the New Equipment business, partially offset by the expected decline in the Service segment.

Adjusted operating profit was up approximately 8% or $36 million, and up $19 million at constant currency as higher New Equipment volume and strong material and Service productivity was partially offset by the impact of lower Service volume, unfavorable price mix and field inefficiencies in the New Equipment business.

Our focus on execution drove 50 basis points of margin expansion in the quarter. Fourth quarter adjusted EPS was up 40% or $0.19, driven by $0.05 of operating profit growth and $0.11 from a lower adjusted tax rate. As Judy mentioned earlier, these results were $0.10 ahead of prior outlook, driven by better than expected growth in the New Equipment business, increased benefit from material productivity, and a slightly better Service pricing environment.

Moving to slide 7. New Equipment orders were down 3.5% at constant currency. A strong order intake in EMEA and Asia driven by China that was up double-digits was more than offset by a 21% decline in the Americas due to a tough compare and weakness in the Northeast and larger metropolitan areas in the western region of United States.

Awards, which typically precede order booking by a couple of months, were stable in the quarter in North America. Net booked margin adjusted for mix was down 50 basis points in the quarter and backlog was up 2% at constant currency, driven by growth in the Americas, Europe, and China with overall backlog margin down slightly versus the prior year.

New Equipment organic sales were up 4.8% with Americas and EMEA up about 18% and 5%, respectively, driven by strong backlog conversion. This growth was partially offset by a decline in Asia. At constant currency, adjusted operating profit was up $7 million in the segment and margin expanded 20 basis points as higher volume and strong material productivity more than offset incremental investments in China to develop agent and distributor channel, unfavorable price mix, and field inefficiencies.

Service segment results on slide 8. The number of units under maintenance contract increased by 2% and modernization orders were up 4.9% at constant currency as double-digit growth in Asia, driven by the mandated regulatory upgrades in several markets, was partially offset by lower order intake in the Americas and EMEA.

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Service organic sales were down 1.4% in the fourth quarter with contractual maintenance demand up slightly while discretionary repair and modernization projects were pushed out. However, we were encouraged by the repair business improving sequentially over the prior periods with a lower year-over-year rate of decline compared to the second and the third quarter.

Adjusted operating profit margin expanded 70 basis points and profit grew $8 million at constant currency. A strong contribution from productivity was partially offset by the impact from lower volume. The service pricing environment excluding the impact of price concessions was modestly favorable.

Overall, full year results on slide 9 reflect solid performance with $52 million of adjusted operating profit growth at constant currency and 70 basis points of margin expansion despite organic sales being down 2.1%. The Service business was particularly resilient, growing adjusted operating profit at constant currency by $55 million and margin by 100 basis points, notwithstanding a slight decline in organic sales as the focus on productivity initiatives continued to yield results with maintenance hours per unit down close to 6% versus 2019.

Despite the environment, we are pleased with the operational progress we made in New Equipment business. Operating profit was down $45 million at constant currency and 4% organic sales decline, with decremental margins more or less in line with the contribution margins. We achieved the goal of 3% material cost savings in 2020, partially offsetting the headwinds from COVID-19 pandemic that resulted in lower volume, the associated under absorption of cost, field inefficiencies and higher bad debt expense.

Cost containment efforts were also a large contributor to profit growth, and full-year adjusted SG&A expense was down close to $40 million versus prior year. At the same time, we maintained the investments in R&D and other strategic project at 1.6% of sales, which was about flat versus the prior year.

Full-year adjusted EPS was up 12.5% or $0.28 versus the prior year, driven by $0.07 from strong operating performance and $0.15 from the progress we are making on reducing our adjusted tax rate, down 370 basis points to 13.4%.

Net interest was also favorable by $0.06, reflecting the benefit of $350 million of debt repayment and $500 million of refinancing during the year. This EPS performance is not only better than the outlook provided in October but also better than the pre-COVID outlook provided in February on our Investor Day and caps a successful first year as a public company.

As we look forward to 2021, on slide 10, we feel confident of growth across all key metrics given the higher starting New Equipment backlog, resiliency of the maintenance business in 2020, normalizing job site and building access levels, and our focus on operational excellence.

Service callbacks, our proxy for repair volume, is also showing continued sequential improvement. Even though the rate of improvement slowed in Q4 due to the resurgence of COVID-19 pandemic, we do expect year-over-year comparison to turn favorable in the second quarter of 2021.

These encouraging trends combined with a strong foundation we built in 2020 gives us confidence to grow overall organic sales by 2% to 4%, with adjusted operating profit by $125 million to $175 million, with 30 basis points to 40 basis points of margin expansion. We expect sales, operating profit and margins to improve in both segments.

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Adjusted EPS is expected to be in a range of $2.67 to $2.77, up 8% or $0.20 at the midpoint. This year-over-year increase is driven by strong operating profit outlook and a 90-basis point reduction in the adjusted tax rate to 29.5%, partially offset by a $12-million increase in interest cost from the full year impact of debt placed at spin.

We expect free cash flow in the range of $1.3 billion to $1.4 billion with conversion at approximately 120% of GAAP net income. This reflects the strong earnings growth outlook, partially offset by incremental interest and non-recurring tax related payments in 2021. Given our strong working capital performance in 2020, a reduction of more than $90 million or close to 25% from 2019 year-end balances, we are holding working capital flat in 2021 at the midpoint of our outlook.

Our capital deployment plans remain on track and we have completed the previously disclosed $500 million of debt repayment with $150 million payment in January and expect share repurchases of $300 million in 2021, a year ahead of the original schedule at spin.

Taking a further look at the organic sales outlook on slide 11. The New Equipment business is projected to be up between 2% to 5%, driven by accelerated conversion of the backlog that was up 2% in 2020 and the expected return to growth in the market. We expect broad-based recovery with all three regions returning to growth in 2021. Americas up low to mid-single digits, EMEA up low-single digits, and Asia up mid-single digit, driven by growth in China.

In the Service segment, we expect maintenance and repair sales to be up 2% to 4% with maintenance sales going from a stable base and recovery in discretionary repairs that will accelerate post Q1. Modernization sales should be up low to mid-single digits, with Asia Pacific maintaining the growth momentum from an effective go-to market strategy to tap into the demand created by the regulatory requirements and other regions returning to growth as it convert the higher year-end backlog. Overall, the sales growth of 2% to 4% represents a solid turnaround after a difficult 2020 with growth across all regions and all lines of business.

Switching to operating profit on slide 12. We expect operating profit to be up $125 million to $175 million and up $75 million to $125 million at constant currency, reflecting the benefit of volumes returning to pre-COVID levels and continued strong contribution from material and field productivity to offset the headwinds from pricing and renewal equipment market, increases in commodity prices, step-up in maintenance expenses, and incremental stand-alone costs in the first half of the year.

This outlook represents the third consecutive year of strong earnings growth as we continue to execute the basics, deal with the challenges, leverage the investments we have made in the business, and benefit from a market recovery.

And with that, I'll request Justin to please open the line for questions.

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QUESTION AND ANSWER SECTION

Operator: And thank you. [Operator Instructions] And our first question comes from Jeff Sprague from Vertical Research. Your line is now open.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Thank you. Good morning, everybody.

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

A

Good morning, Jeff.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Good morning. Hey, I'm wondering if you could just elaborate a little bit more on – I guess, it's kind of a multifaceted question, but all of this is somewhat interrelated. The topics of unfavorable price mix and some of the pressure you might be seeing on the OE equipment side and how that dovetails with your productivity efforts to offset that.

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

A

Sure. Morning, Jeff. So, we've seen earnings momentum going into 2021 with earnings up close to $50 million in the second half of 2020. And we are projecting to continue this momentum into 2021. So if you look at the New Equipment segment, there's a couple of drivers that are driving the growth in 2021 on the earnings side.

The biggest piece of that is the segment returns to growth in 2021 after a challenging 2020 with 3.5% organic sales growth at the midpoint. And the drop we will get from that is a strong contributor to earnings growth. Along with strong material productivity, we still think we can deliver the 3% material cost productivity after absorbing the impact from commodity headwinds.

And this along with the restructuring actions that we took last year will help us offset the incremental stand-alone cost, headwind from some of the actions that we took, some of the short-term actions that we took last year to protect the earnings, and any adverse pricing that may materialize. I mean, the pricing was more or less stable. I mean, we were down slightly on the backlog. So we expect some headwinds on pricing, but we're obviously building that into our guidance.

So the key here is that we are able to grow margins of the New Equipment side despite the commodity headwinds, increase in stand-alone costs, temporary costs coming back, and the pricing pressures. This has been the key part of our strategy. We've been talking about it since our first earnings call back in April last year that we understand the challenges we are facing and we have these operational excellence programs that we are working on whether it's backlog acceleration or material productivity to deal with anything that may arise. So, we feel good about where we sit here today right now, Jeff.

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

A

Yeah. Let me just add one thing, Jeff. When we stood up at Investor Day, I think you heard Rahul and I both set a target to end 2020 at a higher backlog and to go into 2021 with a higher backlog than we entered 2020. And that was something we've reiterated at every earnings call. And with this 2% and improved backlog conversion, we really think that's going to make a difference in New Equipment in terms of driving the revenue and then we'll get the fall-through – drop-through.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

And maybe just one kind of related follow-on. Have you found that your actual realized margin is consistently coming in above kind of the booked margin at the time of order? How did that play actually through the year and in the quarter?

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

A

Yeah. No. It's coming in – our operational excellence not only is based in what we do in the factory but also it's equally important what we do in the field. And we track that thing very, very closely, Jeff. Every month, every quarter, we get reports from every country around the world. And our delivered margin consistently is above our booked margin.

So, that – and that will be – we'll continue to push that and along with pushing material productivity in the field as well. So, the booked – the delivered margin is higher than our booked margin.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great. Thanks a lot guys. Appreciate it.

Operator: And thank you. And our next question comes from Nigel Coe from Wolfe Research. Your line is now open.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning, everyone. I just wanted to – I mean that – I think there's a [indiscernible] (00:26:26) about the orders down 4%, backlog up 2% versus the sales outlook that it's 2% to 5% for equipments. Now, you've clearly got some very easy comps in 2021. But would you expect [ph] the build in backlog (00:26:46) as you ship from that backlog to achieve maybe the high end of that range? Or are you expecting orders to accelerate through the year? Just any color in terms of the forward look would be helpful as well.

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

A

Yeah. So, I mean, Nigel, good morning. It's Judy. Look, there's a few questions in there. We do expect orders to accelerate. I think we've shared that two-thirds of our book that we will execute on in 2021 is in backlog. The rest is kind of book and bill type business for us across the board, both New Equipment and Service. So, we do expect it to accelerate and we will be using 2021 to fill the 2022 backlog so that we go in strong and keep this momentum going.

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Orders on any quarter basis aren't really the best determinant. They do go up and down. There's different levels in different regions. But we did have – we do have – we were down 3.5% at constant on the New Equipment side. I would point out our modernization orders were up almost 5%. So, that business which we see is a growing opportunity for us as well. Even with all the discretion that's been happening in modernization, our modernization orders are up.

Rahul Ghai

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

A

The other way, Nigel, just to add to that is that you can almost look at the – the guide of 2% to 5% with our backlog up on the New Equipment revenue. With our backlog up 2%, you can almost look at that as a floor, right, because that's what we're starting with. And then, Judy mentioned about the acceleration of backlog. We demonstrated that in the fourth quarter of 2020 driving substantially higher organic revenue than where our starting backlog was at the beginning of the quarter. So, that shows the steps that we are taking to accelerate our backlog conversion is happening and we'll continue that into 2021.

And then obviously, the markets are coming back and that is what Judy was talking about. We expect – and Judy shared the data that we're expecting growth across the world with Asia up mid-single digits. So that helps the growth as well. But you start with the 2%, add on the backlog conversion, and then add on the market recovery, that gets us to the 2% to 5% range.

Nigel Coe

Analyst, Wolfe Research LLC

Q

Thanks for the detail. I'll leave it at that. Thanks so much, guys.

Operator: And thank you. And our next question comes from Steve Tusa from JPMorgan. Your line is now open.

Steve Tusa

Analyst, JPMorgan Securities LLC

Q

Hi. Good morning.

Judith F. Marks

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

A

Hi, Steve.

Steve Tusa

Analyst, JPMorgan Securities LLC

Q

Hey, just to be clear. I think the organic backlog was influenced a bit by forex too, right? The organic backlog is actually up a little more than that?

Rahul Ghai

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

A

Yes. Absolutely, Steve. The – at constant currency the backlog is up 2% which is what we – which is what we're talking to. But at actual FX, we benefited from backlog conversion. That's heading up about 6% at reported numbers.

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Steve Tusa
Analyst, JPMorgan Securities LLC

Q

Got it. At reported numbers, right. Okay. Got it. I might have missed that and got that wrong. Just on the services growth. Is there anything in there that's reading through from what you're doing specifically around the technology? Or is it kind of too early for that to show up in the services growth rate for 2020?

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

A

Yeah. I think, we're starting to see the benefits of the IoT, Otis ONE, investment. We're clearly seeing the benefits, the productivity benefits of all the apps that our field professionals have and are being able to put in play. But Otis ONE, we're starting to see that. We deploy just about 100,000 new units in Otis ONE primarily in China, EMEA and in the North America.

And there's real demand pull for that from our field professionals. It's really giving them that advance look, that ability to be able to fix things remote, and to really bring down our callbacks. Our retention rate, we think that's really where you're going to see this in the retention rate. And our retention rate, we ended the year at 94% which is industry leading and is up from earlier in the year when we were closer to 93%. So, we're seeing it there.

And then the reason we believe in it, we're going to be deploying at least that same number this year. And we're also now prepositioning our Otis ONE on our units that we're shipping from the factory. It's already started in China. We're adding the US, EMEA and Asia Pacific. That'll take some time to work its way through obviously the warranty period a year or so in those places, but we believe in it.

And we're seeing the early returns and we're seeing the productivity gain. And our customers are able to really have that access for really operational knowledge whether they're onsite or not, is my elevator working, am I getting more uptime. And we think that's just going to buy more stickiness, and that's the whole thesis of our connected strategy.

Steve Tusa
Analyst, JPMorgan Securities LLC

(

And then just one last one just on China. Pretty decent orders number. Can you maybe just clarify what types of differences you guys may have in exposure versus your kind of more visible publicly traded peers within China? They make comments all the time, but sometimes it's tough to read directly through from what they're saying. So what's your outlook on China and maybe how may you be different than those guys? And I'll leave it at that. Thanks.

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

A

Sure. Let me just kind of look back at China for 2020. As we started at Investor Day, we thought it was going to be a flat segment. The New Equipment segment really had mid-single digit growth, and we held our own to slightly up. We also had high-single digit growth in our portfolio in China, which is key as that becomes a large market for us for the installed base.

Where we gained share on the order side, Steve, was really in the office, commercial and infrastructure markets in China as we really look at the back half of the year. And we're seeing that kind of roll through in January as

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well. Our high-rise business continues to perform well. And we made a lot of investments in China since we became independent.

And this whole expansion, significant expansion, 850 agents and distributors that are helping us get – garner more key accounts, which then have a higher conversion rate, it's really – last year was a great investment year for us in China to build the foundation. We had strong results as the market came back, and we expect strong results as that market grows and we expect to outgrow the market this year in 2021.

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

A

And Steve, just to add to that, that we continue to do really, really well in the Tier 3 to Tier 6 cities and that has been our bread and butter. We've done well over the last five, six years there. We continue to gain share in those markets. And those markets were slightly slower to recover than the Tier 1 markets.

And that's where we need to do the work as we've previously discussed. That's the part where some of our publicly traded peers have a slightly stronger share. But I think the agents and distributors that we've added this year, with that, we are confident we'll do better next year or in 2021 in those Tier 1 markets as well. But our success in 2020 was in the Tier 3 to Tier 6 cities.

Operator: And thank you. And our next question comes from Cai von Rumohr from Cowen. Your line is now open.

Cai von Rumohr
Analyst, Cowen and Company, LLC

Q

Yes. Thank you very much. Nice results. So your maintenance units were up 2% in the fourth quarter. My recollection is they were up 1% in the third. Can you comment how much of that is organic versus acquisition and maybe trends outside of China?

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

A

The 2% was a full-year number, Cai. So that's a full-year number. So, I think that's where we ended up – ended the year and the growth that we saw in the quarter was all organic. There was – I don't think there's any acquisition worth speaking about. So, it was all organic.

Cai von Rumohr
Analyst, Cowen and Company, LLC

Q

I mean, am I correct, I think you published that the third quarter, the units were up 1%? So if 2% is for the full-year, what was the fourth quarter?

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

A

So, it depends on where – it just depends on you should – the way you should look at it is where we ended Q3 last year versus Q3 of 2019. It's in year-over-year growth. But for the – like this is a Q4, it's a balance sheet

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number, right? That's the way to think about it. So it's in Q4 of 2020, at the end of 2020, we ended up at 2% higher units versus where we ended at – we ended in 2019.

Cai von Rumohr
Analyst, Cowen and Company, LLC

Q

Terrific. And then, on the raw material front, refresh my memory. Is it the percent of raw materials, the absolute number of raw material purchases, what percent is stainless steel? Because stainless basically what it did, it's hopped something like close to 20% since the middle of the quarter.

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

A

Yeah. So, our commodity spend, Cai, is about – total quantity spend is about $300 million, out of which about 80% is steel. And you're right. As we look at kind of what we are seeing right now for 2021, steel is about 7% to 8%, maybe higher – a little higher in Q1 right now, and the fall was a little bit lower. So the average is out about 7% to 8%. So the way we're thinking about the commodity issue for next year is it was a tailwind in 2020. It's – for 2021, it is a headwind given where the steel prices sits today.

And the spreadsheet map would suggest, hey, that could be a like a $20-million plus headwind for us. But the other part that has simultaneously happened is that both euro and the renminbi have appreciated against the dollar. And we buy in local currency in both Europe and China. So we should be able to offset part of this commodity increase by just appreciation of the local currency. So, that's one piece of it.

The second piece is that we are working really, really hard on material productivity to offset the commodity headwinds. I think that's what Judy said earlier. And we're starting 2021 in a much, much better position than we did in 2020 given the cadence that we gained last year. And our carryover benefit from the projects that we started midyear in 2020 is higher than where we were at this point last year. So, we still think we can deliver 3% material productivity after absorbing the commodity headwinds and grow our New Equipment margins, which is what i said earlier in response to Jeff's question.

The other piece, to the extent that dollar weakness is causing the commodity headwinds, we're also seeing the $50 million FX gain on our earnings overall. So, it's in a different line of the P&L. But some of the commodity weakness is because of appreciation of – the depreciation of the dollar. But we gain that on the overall earnings side, so a little bit of a trade-off. But overall, it is an issue but it's built into our guidance and we feel we can get to 3% material productivity and grow our New Equipment margins in 2021.

Cai von Rumohr
Analyst, Cowen and Company, LLC

Q

Thank you very much.

Operator: And thank you. And our next question comes from Julian Mitchell from Barclays. Your line is now open.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning.

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

A

Good morning.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Good morning. Maybe just a couple of clarifications really. One was around the free cash flow outlook. There isn't a lot of growth dialed into that guide despite a reasonable adjusted earnings increase.

So, just wondered any sort of split there around working capital versus CapEx and if you've seen any change in working capital terms perhaps as some of your customers are fairly squeezed. And then a very quick clarification. Just non-controlling interest, I think, was lower year-on-year. So, just trying to understand that.

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

A

Yeah. So, let me start with cash and then we can talk about the minority JV payment. So if you look at our cash, really strong year last year. We ended $150 million better than what we had guided and net income came in better. Working capital was really, really good. And as I said in my prepared remarks, we reduced working capital by $90 million, which is a quarter of our working capital, which was a fantastic performance given what you hear overall.

And as we look at 2021, the biggest driver is improvement in earnings, Julian, as you referenced, but there are two issues that we are trying to deal with next year. One is just the timing of the interest payments. So – and just the way where the interest payments landed, we do have an extra interest payment in 2021, which we did not have in 2020 given the timing of when we raised debt.

The other issue is that we do need to make a tax-related payment for an old tax matter that we've inherited from UTC. So, we built that into our guidance as well. That matter is still ongoing, but we built that into our guidance.

Our – as I said in my prepared remarks, we have not built any working capital improvement into our guidance. At this point, we'll obviously keep working at the midpoint of our guidance because when we'll keep working – we'll keep working that hard. But our plan at this point doesn't contemplate that. $1.35 billion for 2021 is a solid number. It's 120% of GAAP net income and substantially higher than where we expected 2021 to be on Investor Day. So, we think it's a solid start to the year.

On NCI for 2020, not any one single driver. It was a combination of various things, a couple of moving here there and then FX is a little bit of a headwind as well. So, I wouldn't read too much into where we ended on NCI for 2020.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

Operator: And thank you. And our next question comes from John Walsh from Credit Suisse. Your line is now open.

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John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning.

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

A

Good morning, John.

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

A

Good morning.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

So, it was great to hear and it sounds like there's a lot of excitement around the new products and rolling them out across the different geographies. I guess, one of the questions I had is as you roll these new products across US, EMEA, China, APAC, do you believe that these new products are ahead of where your other kind of public competitors are? Are these to get you to be in line because you've talked about making these investments?

Or do you think that there's still some other folks that might still be leading even with these new products? I'm just trying to understand kind of the competitive dynamics there with a lot of these new launches, if you're kind of leaping ahead or if this is to kind of get back in line with where some of the market already is.

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

A

Yeah, John. It's a little of both. And we've increased our R&D investment 60% since 2015. And we've made – actually, we've done really well. Our patents have gone up four (sic) [three] times since that same period. And our new product releases since 2018 are up 250% (sic) [200%]. So, we've made a conscious effort to really reinvigorate the innovation engine and the DNA in this company.

So, some of that is a little bit of catch-up. But others like our GEN360 is going to be an incredibly new, digitally native with an electronic safety-first in the industry that code authorities have to approve. It's going to revolutionize really how people are gracefully handled when there's an issue in the elevator and the elevator has to actually stop. It's going to gracefully bring them down to an actual landing floor, so that customers and more importantly passengers aren't entrapped at any length of time.

So, our destination dispatch product we believe is industry-leading. We've released the Compass 360 product that gives us even more capability. And we found customers are really very interested in that whole destination product because it's touch-free. And we've always talked about the safety of our products. Now we also talk about the health offerings of our products. And our team moved very rapidly during the COVID era to generate new products, whether it be gesture, whether it be our app, our e-call app that allows you either via Bluetooth or other connectivity to use your phone.

And then we've tried not just to hit the high end with the GEN360 in terms of complexity and features. We've also tried, as we talked about, our Gen2 Prime to find a nice, stable, affordable entrant that's – that'll be a workhorse for us in India, in the Middle East, in Africa, in other emerging markets. So, we're trying to hit that whole span.

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On the Service side, when we rolled out Otis ONE, we made a conscious decision to roll it out as a productivity enabler first. And we think we're going to drive one point of productivity with Otis ONE and we're going to keep adding units to do that. The reason we did that and the strategy we did that that we took was a density-based approach.

We – there's not value – as much value if you just sprinkle sensors or IoT units across the globe. So, we did a very focused, density-based, route-based attempt and focus to be able to actually yield that productivity. And that will grow in productivity, but it will also grow in terms of customer value and retention for us and it provides a foundation for us to add services.

So, a little bit of catch up. No argument based on some prior years' lack of investments pre-2015, but I think we've really accelerated both in the mechanical, the digital, the electronic, and most importantly, the passenger experience.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you for that answer. And then just as a follow up, looking at the Americas orders growth, and I know any one quarter can – isn't maybe necessarily the best data point and they need to be looked at probably over a four-quarter period. But can you remind us what your order to ship is right now in the Americas? Because I'm just trying to figure out elevators typically lead and how to kind of roll through these negative orders we've seen in the Americas through the model. And I think you also talked about awards being kind of stable. I didn't know if that was a Americas comment or a total portfolio comment. Thank you.

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

A

Yeah. No. John, so the typical I would say – the order to the ship time on elevators is about 12 months in North America. I mean I think that's what we've said before. So, that's where we are. The comment on awards which typically precede orders by a couple of months and they were stable in the quarter, that was a North America comment.

But if you look at Americas overall, John, I think the markets are kind of uncertain, right? I mean we're seeing – as Judy mentioned in her prepared remarks, we're seeing good growth in Asia, we kind of feel good about the mid-single digit growth there. If you look at EMEA, we feel good about the low-single digit. Americas remain challenging and the market was down mid-teens last year. So, obviously, we did better than the market.

And if you look at the Dodge Momentum Index, that just turned strongly positive in December for the first time in several months. So, that's an initial sign of recovery since COVID. But if you look at the Architectural Billings Index, that's still under 50. But now the inquiries have been positive for four months straight. So kind of mixed signals. And if you look at the range of guidance that we are giving, that – part of that range is driven by the Americas' growth outlook, so that's a contributor to that.

But overall, again, I think we discussed with Nigel earlier, we feel good about all the steps that we've taken in terms of improving our sales coverage. Kind of 7 points in China, 10 points overall. New product introductions. Our proposals were up 7% last year. So, that obviously is another good sign that we can keep building on this momentum that we have and the share gain that we've enjoyed, we can keep building on that. But Americas market is uncertain, but that's what we built into our guidance.

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John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thank you.

Operator: And thank you. And our next question comes from Carter Copeland from Melius Research. Your line is now open.

Carter Copeland
Analyst, Melius Research LLC

Q

Hey. Thanks and good morning, everybody.

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

A

Hey, Carter.

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

A

Good morning, Carter.

Carter Copeland
Analyst, Melius Research LLC

Q

I wondered could you speak specifically to conversion rates? I think at one point in time, you talked about giving those sort of once a year and even if you can't give us the exact number, just some of the regional trends, data, any color on that on just how you finished the year in terms of conversion.

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

A

Yeah. Let me start and I'll give you more of some regional flavor and then Rahul can add. We saw a strong conversion growth and uptick in China, which is the most encouraging for us because that's obviously the largest at over 50% of the segment. That's our largest opportunity base to grow our service portfolio. And the service portfolio, as I mentioned, we had high-single digit growth in there. So, we saw a nice conversion and our retention rate went up in China as well as did our recapture rate on units we wanted to get back.

So, all three metrics that help drive net recovery for us in China were positive and we think that's the strategy playing out. Everything we've told you about enhanced customer stickiness, IoT, more key accounts which have higher conversion rates closer to the 80% range, more infrastructure which also has higher conversion rates. So, with that pivot in our strategy in China, that's where we're seeing that accelerate.

Rahul, do you want to comment on the [indiscernible] (00:49:41) at the macro level?

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

A

Yeah. The overall conversion kind of hung in there at about 60-ish percent Carter, so not a lot of change to the overall conversion. As Judy said, China was up about 1.5. So that was good momentum. And the other – only other thing is the retention rate for us which is very, very critical was at 94% in 2020 was at 93% in 2019. So that

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picked up as well. So that's good. So good momentum in the Service business. Obviously, you saw that come through the results as well.

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

A

Yeah. The other thing I'll just comment on, Carter, just from a Service pricing what we saw, if you hold concessions off, they still exist and we believe they're still going happen in 2021 – in the early 2021 in the hospitality parts of the business and retail. Our Service pricing held well as we finish 2020. So, not only were we getting the conversions and keeping the retention, we were getting – we were holding price if not to slightly up.

Carter Copeland
Analyst, Melius Research LLC

Q

So based on those trends, presumably you expect your Service portfolio growth to accelerate in 2021 versus 2020, I would assume.

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

A

Yes.

Carter Copeland
Analyst, Melius Research LLC

Q

Okay. All right. Thank you very much.

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

A

Thanks, Carter.

Operator: Thank you. [Operator Instructions] And we have a follow-up question from Nigel Coe from Wolfe Research. Your line is now open.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Oh, thanks for the follow-up. Appreciate it. And just – Rahul, I'm just wondering if you can maybe just size that tax number you've got dialed into your forecast. And then maybe just clarify the $20 million of raw material at that – sort of like dialed into your budget. Is that the kind of the growth impact or is that net of productivity or FX movements? Is that just the pure increase in stock prices?

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

A

No. $20 million is just a commodity piece. We think we can – we will offset that, Nigel, with the 3% material productivity. And we will deliver 3% net productivity after absorbing the $20-million headwind. So, that's just the commodity piece.

On the tax, it's kind of in tens of millions, Nigel, so it's a big number. It's not a small number. It's a tax matter. So, we will continue to deal with it. Again, no P&L impact. The P&L is all accrued. It is basically a cash outflow for us in 2021.

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Nigel Coe
Analyst, Wolfe Research LLC

Q

That's like a separation type number, does that care up the separation matters, more or less, at this point?

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

A

There will be a few tax matters that will continue. We had this old toll tax if you guys remember from – if you guys have been following Otis for long, and that will continue for a few years. But that's not a year-over-year change, Nigel. And that's in the $15 million to $20 million of cash outflow every year. So that's not a big number. But this is one of the biggest issues that we have remaining from the separation.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. Thank you very much.

Operator: And thank you. And now I would like to turn the call back over to Judy Marks for closing remarks.

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

Thank you, Justin. To summarize, we delivered a strong close to a solid first year as an independent company. I'm pleased with the performance we delivered against a challenging economic backdrop. Nearly a year ago, we held our Investor Day at the New York Stock Exchange. We shared with you the strength of our portfolio, our long term strategies to deliver growth and profitability, our track record of execution, and our commitment toward disciplined capital allocation, all to drive shareholder value.

We laid a strong foundation, and the target set out for 2021 reflect the resiliency of our business model and the strength of our long-term strategy. Our fundamentals remain strong. We're well positioned to continue driving value for our customers, for our colleagues, and our shareholders. I hope you all stay safe and well. And thank you for joining us.

Operator: Thank you. Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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