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Otis Worldwide Corp. (OTIS)

Q4 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Otis' Fourth Quarter 2021 Earnings Conference Call. This call is being carried live on the Internet and recorded for replay. Presentation materials are available for download from Otis' website at www.otis.com. I'll now turn it over to Michael Rednor, Senior Director of Investor Relations.

Michael Rednor
Senior Director-Investor Relations, Otis Worldwide Corp.

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Thank you, Kathryn. Welcome to Otis's fourth quarter 2021 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 non-recurring items. The company will also refer to adjusted results where adjustments were made as though Otis was a standalone company in the current period and prior year. A reconciliation of these measures can be found in the appendix of the webcast. We also remind listeners that the presentation contains forward-looking statements which are subject to risks and uncertainties. Otis' SEC filings including our Form 10-K and Quarterly Reports on Form 10-Q provide details on important factors that could cause actual results to differ materially.

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

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

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Thank you, Mike, and thank you, everyone for joining us. We hope everyone listening is safe and well. We delivered a strong close to an excellent year despite ongoing macro challenges. These results are a testament to the strength of our strategy and the dedication of our colleagues to execute and deliver results for our customers and shareholders.

We achieved broad-based organic sales growth, grew adjusted operating profit for the third year in a row, delivered 19% adjusted EPS growth, and generated $1.6 billion in free cash flow while introducing new, innovative solutions for our customers and passengers. We remained committed to shareholder value creation and strategically deployed capital, completing $450 million in debt repayment, distributing over $390 million in dividends after raising the dividend 20% versus the prior year, and repurchasing $725 million Otis shares, given the strength of our balance sheet we also announced our tender offer for the remaining interest in Zardoya Otis, an accretive transaction for Otis.

New Equipment orders were up 7.3% in the fourth quarter and up 13.2% for the year with broad-based growth. In Asia Pacific, we received an order for nearly 280 units supporting Taiwan Taoyuan International Airport's new Terminal 3 building and concourse. This includes 92 escalators, 60 moving walkways, and more than 120 Gen2 elevators equipped with ReGen drive technology that will support the terminal's smart and green design.

In November, we received an order for Sawyer's Landing in Miami Florida, this project extends its decade-long relationship with the developer, and Otis will install over 20 elevator and escalator units. Additionally, Concord Pacific, one of the largest developers in Canada has selected Otis to support its King Landing (sic) [King's Landing] project in Toronto, Ontario extending our nearly decade-long relationship. We'll provide more than a dozen elevators for this mixed use high-rise.

These orders demonstrate the power of long-lasting relationships and our continued investments in providing innovative solutions for our customers. Our strong orders momentum throughout the year led to approximately 115 basis points of New Equipment share gain on top of 60 basis points in the prior-year.

In addition to executing on our financial priorities, we remain committed to advancing our ESG initiatives. Our Gen360 next-generation digitally native elevator platform was awarded two environmental product declarations. This platform is positioned to revolutionize our customer and passenger experience while providing energy efficiency benefits that help to reduce the impact on our planet. Gen360 joins our existing suite of energy efficient products such as the ReGen drive, which can distribute power back into a building.

Also in China, we received several awards that recognize our team's achievements in leadership, innovation, and sustainability including recognition as a 2022 Top Employer by the Top Employers Institute.

And finally, last week Otis was recognized for the second year in a row as a Best Place to Work for LGBTQ Equality by the Human Rights Campaign. This award demonstrates our leadership in creating an inclusive culture where all voices feel safe, welcomed, and heard.

Now moving to slide 4. This year, we grew our industry-leading maintenance portfolio by 3%, our best portfolio growth rate in over a decade. This accelerated maintenance portfolio growth is a key part of our long-term strategy, equally important is the digital connectivity of units in our Service portfolio, and this year, we deployed approximately 100,000 Otis ONE units bringing total portfolio connectivity to about one-third of our approximately 2.1 million units under our service. Over the medium term, we plan to increase connectivity to approximately 60% of units, up from roughly 25% at the end of 2020.

Our operational initiatives also progressed as we rationalized adjusted SG&A expense down 40 basis points as a percentage of sales, and reduced the adjusted effective tax rate by 190 basis points. This represents significant progress in rightsizing our costs and optimizing our tax structure as an independent company.

I am pleased with our performance in our second year as an independent company as we delivered strong financial results and advanced our ESG initiatives. You can expect to hear more in the coming months with the publishing of our first ESG Report.

Now turning to slide 5 and starting with the 2022 industry outlook. While market dynamics remain fluid, the industry's long-term fundamentals are solid. We're encouraged by the strong recovery experienced during 2021, and have confidence this momentum will continue into 2022 in many regions. The New Equipment market is expected to be up mid-to-high single digits in the Americas, low single digits in EMEA, and down mid-to-high single digits in Asia driven by uncertainty in China where we expect the market to be down 5% to 10%.

While the China New Equipment market faces headwinds this will not detract from solid growth in the Service installed base where approximately 1 million units are added each year to the global base, a mid-single-digit growth rate annually. Industry installed base in the Americas and EMEA are expected to grow low-single digits, and in Asia we're expecting high single-digit growth driven by China.

Service is the foundation of our business and we expect to grow our service units up by more than 3% in 2022, and to eclipse 2.2 million units under maintenance remaining the largest service portfolio in the industry.

Here's our 2022 financial outlook. For the year, we expect organic sales growth of 2.5% to 4.5%. Net sales will be in the range of $14.4 billion to $14.7 billion, up 1% to 3% accounting for FX headwinds. Adjusted operating profit is expected to be in the range of $2.24 billion to $2.3 billion, up $95 million to $165 million excluding the expected impacts from foreign exchange. At actual currency adjusted operating profit is expected to be up $50 million to $120 million. Adjusted EPS is expected in the range of $3.20 to $3.30, up 6% to 10% versus the prior year, and $0.24 at the midpoint. Lastly, we expect free cash flow to be robust at about $1.6 billion or approximately 115% to 120% conversion of GAAP net income.

We remain highly disciplined in our capital allocation strategy committed to meeting the needs of all stakeholders through dividends, debt paydown, bolt-on M&A, and share repurchases once we complete our deleveraging plans associated with the acquisition of the remainder Zardoya.

With that, I'll turn it over to Rahul to walk through our 2021 results and 2022 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 were up 2.2% to $3.6 billion. Organic sales grew for the fifth consecutive quarter and were up 2.8% with growth in both segments.

Adjusted operating profit was up $11 million and up $21 million at constant currency as higher volume, productivity in both segments, and favorable service pricing was partially offset by commodity inflation, and the absence of temporary cost actions taken in the prior year to alleviate the impact of COVID-19.

Fourth quarter adjusted EPS was up 9.1% or $0.06 driven by $0.02 of operating profit growth and $0.02 from a lower adjusted tax rate. Benefit from share repurchases done earlier in the year and reduced interest expense from the repayment of debt contributed to the balance. Adjusted EPS was $0.06 ahead of the prior outlook including the favorability from better-than-expected operating profit growth and tax rate that ended at the low end of prior expectations.

Moving to slide 7. New Equipment orders were up 7.3% at constant currency. Orders momentum remained strong in Asia, up mid-single-digits including the seventh consecutive quarter of growth in China. Orders were up high-teens in the Americas and awards which precede order booking were up mid-single digits in North America signaling continued recovery in the booking trends heading into 2022.

EMEA was flat versus the prior year as mid-single-digit growth in Europe was offset by decline in the Middle East. From a tough compare on major orders, proposal volumes in the quarter also continued to show signs of robust demand globally, up double digits driven by strength in China. Total company backlog increased 1% and 3% at constant currency with growth in all regions including approximately 5% growth in Asia.

Booked margin in the quarter was down slightly more than 0.5 point from a decline in the Americas partially due to customer mix, but the year-over-year trends in the region showed substantial improvement from Q3. This was partially offset by almost 1 point of improvement in booked margins in Asia with EMEA being about flat. Overall, our pricing on new orders were slightly better than our prior expectations.

The backlog margin [year-over-year] trend adjusted for mix was about flat sequentially, and down about 1 point versus the prior year. Full year New Equipment orders were up 13.2% with growth in all regions with Americas up 14%, EMEA up 4%, and Asia up 17% with high-teens growth in China.

In the fourth quarter, New Equipment organic sales were up 1.2% from growth in Asia up approximately 12% including mid-teens growth in China. Growth in Asia was partially offset by decline in the Americas and EMEA driven by tough compares from strong recovery from COVID-19 in the fourth quarter of the prior year.

Adjusted operating profit was down $7 million. Commodity inflation of $35 million that was in line with our prior expectations was largely mitigated by installation productivity and favorable performance on projects.

Service segment results on slide 8. Maintenance portfolio was up 3% from broad based improvements in retention, recapture, and conversion rates. Conversion rate in 2021 was up 3 points globally and up 5 points in China to 45%. This improvement in conversion contributed to high-teens portfolio growth in China for the second consecutive quarter. In addition, our retention rate in 2021 continued to improve and is now above 94%.

Modernization orders returned to growth in the quarter and were up 18.3% at constant currency with growth in EMEA and the Americas. Overall, modernization backlog was up 6% at constant currency. Service organic sales grew for the fourth consecutive quarter up 4% with growth in all lines of business.

Maintenance and repair grew 4.3% with continued robust recovery in repair and low single-digit growth in the contractual maintenance sales. Modernization sales were up 2.2%, slightly below our expectations due to continued supply chain challenges.

Service adjusted operating profit was up $20 million with 50 basis points of margin expansion, the eighth consecutive quarter of margin improvement. Profit growth was driven by higher volume, favorable pricing and mix, partially offset by higher costs from the absence of COVID-19 cost containment actions taken in the prior year. Service portfolio pricing was up more than 1% mainly due price increases in Americas and EMEA.

Moving to slide 9, overall for the full year we carried the momentum from 2020 into 2021 and gained 115 basis points of New Equipment share gains, accelerated the rate of maintenance portfolio growth. Organic sales were up almost 9% with New Equipment and Service up 15.5% and 4.1% respectively. This sales growth, our focus on execution and FX tailwind resulted in $272 million of adjusted operating profit growth.

New Equipment operating profit was up $105 million versus the prior year at constant currency driven by higher volume and installation productivity that was more than double what we achieved in 2020. This, combined with our ongoing focus on material productivity, more than offset the unfavorable price mix and headwinds from commodity price increases of approximately $90 million. Margins in the segment expanded 100 basis points more than offsetting the decline in 2020 and are now above 2019 levels.

Service adjusted operating profit was up $104 million versus the prior year at constant currency, driven by higher volume, productivity initiatives and favorable pricing that more than offset return of cost in the business to support higher activity. Service margins expanded 30 basis points building on the expansion in 2020 and are now 140 basis points above 2019 levels. Corporate segment costs were about flat for the year despite the step up in public company expenses from disciplined cost management.

Adjusted EPS was up 19% for the year from operating profit increase and a reduction in the tax rate that was down 190 basis points for the year. Adjusted EPS was up about 35% from 2019 for a two-year CAGR 16%, substantially ahead of our prior medium-term expectation.

We generated close to $1.6 billion in free cash flow from earnings growth and a rigorous focus on working capital. Working capital is now down more than 50% from 2019 levels.

As we look forward to 2022 on slide 10, we expect Service industry growth rates to be consistent with 2021 across all regions, and New Equipment end markets to show solid growth outside of China. This combined with higher starting New Equipment backlog, strength of the maintenance portfolio and our relentless focus on operational excellence gives us the confidence to improve across all key metrics in 2022, with organic sales up to 2 .5% to 4.5%, and overall margin expansion of approximately 30 basis points. We expect sales, operating profit and margins to improve in both segments at the midpoint.

Adjusted EPS is expected to be in the range of $3.20 to $3.30, up 8% on $0.24 at the midpoint. We expect free cash flow of approximately $1.6 billion between 115% and 120% of GAAP net income. This free cash flow outlook reflects the strong earnings growth expectation partially offset by an approximately $55 million headwind from a one-time tax related payment that was previously expected in 2021 and $20 million in incremental capital expenditures to support digital connectivity initiatives.

Our capital deployment plans remain on track, and we have already repaid $400 million of debt in January with the remaining deleveraging expected to be completed in the first half. Once our target leverage metrics are met, we plan to recommence share repurchases.

Taking a closer look at our organic sales outlook on slide 11. The New Equipment business is projected to be up 0.5% to 3% supported by the backlog that was up 3% at constant currency in 2021. Americas organic sales growth is expected to be up low single digits, EMEA up mid-single digits. Asia is expected to be up or down slightly with mid-to-high single-digits growth in Asia-Pacific. China is expected to be flat to down low single digits as growth from higher starting backlog is offset by decline in the book and ship business.

Service segment growth is broad-based and is expected to be up in all regions with maintenance and repair up 4% to 6% benefiting from a 3% higher starting portfolio, favorable service pricing environment, and a continued recovery in repair. Modernization is expected to be up 4% to 6% from 6% higher starting backlog and easing of 2021 supply chain challenges.

Overall, organic sales are expected to be up 2.5% to 4.5% building on the approximately 9% organic growth in 2021.

Switching to EPS bridge on slide 12, we expect EPS growth of 6% to 10% with operating profit growth of $95 million to $165 million at constant currency contributing $0.16 to $0.27 to the EPS growth. Operating profit will benefit from increased volume in both segments, Service pricing tailwinds, and continued savings from material installation and service productivity initiatives.

This will be partially offset by commodity headwinds of approximately $90 million. Foreign exchange translation is expected to be a $0.07 EPS headwind, mainly from the strengthening of the euro and the yen against the US dollar.

Noncontrolling interest expense from increased profit in China and other JVs will reduce EPS by $0.02 to $0.04. FX translation impact and increase in noncontrolling interest expenses are mostly offset by accretion from the Zardoya transaction.

We now have more visibility into the approval process and are increasingly optimistic in the timing of the delisting and expect the transaction to be about $0.10 accretive in 2022. Lastly, we expect to reduce our adjusted tax rate by an additional 50 basis points to 100 basis points this year adding $0.02 to $0.03 to the EPS. This outlook represents fourth consecutive year of strong earnings growth as we continue to build on strong execution, mitigate the macro challenges, leverage the investments that we have made, and benefit from our continued end market recovery.

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

QUESTION AND ANSWER SECTION

Operator: Thank you [Operator Instructions] Our first question comes from Jeff Sprague with Vertical Research, your line is open.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Thank you, good morning, everyone.

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

Good morning, Jeff.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Good morning. Just a couple to start, just, first on the Americas, it looks like you're guiding Otis below your view of the market. Could you just explain what's going on there, I assume it's backlog conversion, but some color would be interesting?

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

Yeah, Jeff, let me take that. So, we're doing a low single-digit guide in the Americas. Really strong performance this year in the Americas up 14% in orders roughly, and up 14% in sales. So, we are capitalizing on the market as it's growing, and the indices are all looking really positive, both multifamily, non-resi, whether it's Dodge or ABI, everything's looking good really heading into 2022. Our guide is – really reflects project timing on several major projects that don't drive revenue until very late in 2022. It's going to help us in 2023 for these large projects, but it really does drive the majority of the Americas guide.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

And Judy or Rahul maybe if you could just give us a little color on the complexion on the sequential patterns here this year. I would imagine China starts weaker and gets stronger, but would love to hear your view on that. And in terms of price coming through the backlog counteracting the commodities headwinds, how does that play out? Anything you would share on how to think about the jumping off point and how we start here in Q1?

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

Yeah, absolutely. So, Jeff we expect to start the year strong in Service growth compares are easier, I mean, if you go back to Q1 of last year, Q1 was our like – lowest organic growth quarter in 2021. So, compares are easier on Service. And our Q1 growth should be more or less consistent with our full-year guidance, some headwinds from cost coming back since we were still dealing with the pandemic last year, but overall it should be a really, really strong quarter on Service.

Given the tough organic growth compares on New Equipment in the first half with 25% growth last year in the first half of 2021, New Equipment growth will be stronger in the second half, and also commodity headwinds will predominantly be a first half phenomenon. So the first half of 2022, and New Equipment could look like Q4 of 2021 on a year-over-year basis, but sequentially we do expect Q1 of 2022 will be stronger than Q4 of 2021, and on both profit and margin. And then Q2 will show improvement over Q1, so we expect continued sequential improvement in our New Equipment business.

The FX headwind will also be a first half issue, keep in mind euro was about $1.20 in the first half of 2021 and is now trading at $1.11, $1.12 level, the guide for the year is $1.12. So – it, there's headwind in the first half, and as we go into the second half on FX the compares get much easier. So, if we put all of this together, we face some pressure on New Equipment, organic growth, commodities, some FX headwinds but the first half profit growth in Service segment should more or less offset that, and we expect to grow profit kind of in line with our revenue growth in the first half and EPS will improve year-over-year as well.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great, I appreciate it. Thank you.

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

A

Thank you, Jeff.

Operator: Thank you. Our next question comes from Miguel Borrega with BNP Paribas Exane. Your line is open.

Miguel Borrega
Analyst, Exane SA (United Kingdom)

Q

Hi, good morning, everyone. I just have two questions if I may, the first one again on your guidance for New Equipment sales in 2022, you're saying in Asia up or down slightly, but then, if I look at your orders, you have seven consecutive quarters of positive growth, and over 2021, growth has been above mid-teens, call it mid-teens order growth in Asia. So can you tell us – can you help us understand whether it's lead times or developers that are finding it more difficult to pay at delivery or the lead times have just gotten longer into 2022? Thank you.

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

A

Yeah, Miguel, it's Judy. I don't – it's not really a lead time issue. We entered the year and – with our backlog and our China – it's really a China discussion here. Our China backlog is up entering 2022, and that really supports about two-thirds of our backlog occurs in that next year. So we're coming in with about two-thirds of the China backlog, and the remaining third is book and ship. It's the book and ship where I think we're trying to be prudent, not – really watching the trends, understanding whether it's SOE developers or private developers, what's happening. So, we feel that that is what's going to really drive our 2022 performance in China which gets blended into our Asia number. Orders are really strong, but how that converts, and especially the book and ship that is about a third of our volume in any given year globally, but especially in China is our watch item for next year.

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

A

So, let me put a couple of numbers on this, Miguel, just to add to what Judy said. So, if you start with an Asia backlog that we said is up 5%, and within that Asia-Pac backlog is up high single-digit, and China, as Judy said, is up call it 3%. And just to reiterate what – her point about 60% to 65% of our in-year business is driven by backlog. So for China, backlog is up 3%, and that's two-thirds of our revenue, that should drive about 2% growth in the China business. And if the in-year book and ship is flat, so that's the way to think about it. Now, our guidance for China is that China would be down is – would be flat to down 3%. So, despite the overall higher starting backlog which implies the year book and ship to be down between 5% to 10%, right on the remaining that one-third to 40% of the revenue.

And that's largely in line with what Judy commented on the prepared remarks on the China market. Now, there's a chart in the appendix that has our 2021 orders in China versus the market, and our orders out to the market by call it 2x. And if we can replicate that performance in 2022 that would be an upside to this outlook, but it's early in the year, and the China market is very fluid. So we are just being very appropriately prudent at this stage in our guidance.

Miguel Borrega
Analyst, Exane SA (United Kingdom)

Q

That's great. Thank you. And then my second question is just coming back to your margin guidance, and specifically for New Equipment. And can you give us more color on the trajectory is this going to be perhaps a second half weighted profit year for new installations?

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

A

Yeah. I think that is what I said kind of in response to Jeff's question. On New Equipment, absolutely, I mean, the commodity headwinds we're calling for about $90 million, most of that is going to be in the first half. We have some commodity headwind kind of dialed into the second half, just given the volatility that was there last year. But if the commodity headwinds, the commodity prices continue to go the way they're going, commodity could be a little bit less of a headwind, but right now, we've kind of dialed in $90 million. And again, that could – given the fact that the growth is going to be a little slower in the first half versus the second half, commodity headwinds being a largely first half issue, we do expect our New Equipment margins to be slightly challenged in the first half and then with improvement in the second half of the year. And overall, as I said, to Jeff's question, we do expect that our profit growth will be in line with our revenue growth in the first half, right. So we don't expect margins to shrink in the first half of the year because of the service growth

Miguel Borrega
Analyst, Exane SA (United Kingdom)

Q

Great, thank – yeah, great, yeah, got it. And then, just one last question on your capital allocation strategy, you suspended the share buyback because you're now focusing on deleveraging post the acquisition of Zardoya. If I'm correct, this would still imply below 2 times net debt to EBITDA for next year – for 2022. Can you remind us the normalized level that you're seeing the business operating from? Thanks.

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

A

So we'll be about – we are not getting below 2 times by the end of the year, I think we're getting to 2.1 times by the end of the year. But again, I think we feel very comfortable with our debt levels. We are – of the $500 million of deleveraging, we've already done $400 million, we've got $100 million to go. And depending on when we can repatriate the cash back to the US, and we will start our share buyback. So that's what we've guided to is that fact that we will recommence share buyback once our debt repayment is complete. So that's on track. And so, once we get little bit more clarity on the repatriation of cash, we'll provide additional guidance on share buyback for the year.

Miguel Borrega
Analyst, Exane SA (United Kingdom)

Q

Thank you very much.

Operator: Thank you. Our next question comes from Julian Mitchell with Barclays. Your line is open.

Julian Mitchell
Analyst, Barclays Investment Bank

Q

Hi, good morning. Maybe just wanted to circle back, apologies, to China New Equipment revenues for a second; so, I think you've said, Rahul, that those would be down – flat to down low single-digit in 2022 from sort of a revenue standpoint. Just wanted to understand, sort of, again just, how you're thinking about that sort of first half and second half, and how you would expect your orders in China New Equipment to trend going through this year. Just trying to understand that sort of relationship between the orders booked in China and then when they're sort of being billed in the P&L?

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

A

Yeah, so Julian, good morning. And just to clarify what I said earlier maybe – we expect our China New Equipment revenue to be down – to be flat to down 3%, so that's the revenue growth expectation on the New Equipment side for China, so flat to down 3%. We're going in with higher starting backlog, and that backlog is up about 3%. So that should support what my comment was that that should – if the book and ship business for the year is flat year-over-year that will drive about a 2% growth considering the backlog is about two-thirds of the revenue.

Now, if our guide is flat to down 3%, that would imply that the book and ship business is down, kind of, call it 5% to 10%, right, at the higher end or the lower end of the guidance, which is kind of in line with the overall market is what we are seeing. Now, again, just to repeat what I said earlier, we have done a lot better in China on orders in 2021, and [ph] we had (00:33:37) almost at 2x the level of market growth. So that – we've not factored that in into this guide, so hopefully if we can do a little bit better on orders than the market, that should drive some upside.

In terms of the first half, second half, listen, the market is going to be little bit softer in the first half. Again, part of that is just the compares because the market was very, very strong in the first half. It was up about 16% through the first nine months of the year, and ended about – and was about flat for the fourth quarter. So the market is definitely stronger in the first half last year, so that should drive some tougher compares into 2022. And I think our order trends are obviously going to mirror that a little bit.

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

A

Yeah, let me just add two things, Julian. If you context that the segment's about 650,000 units for New Equipment in China. Even if that's down 5% to 10% happens in the segment at the 10% level, we're back to 2020 levels for the China segment, so it's still healthy. We've gained share for for the last two years in China. The team's performing incredibly well. We actually had record unit orders in 2021. So, we've got momentum with us, but we're trying to be prudent to watch some of the volatility that's happening.

Julian Mitchell
Analyst, Barclays Investment Bank

Q

Thanks very much. And then maybe just a step back from the quarterly moving parts. Two years ago, at the Investor Day, you talked about 20 to 30 basis points of sort of annual operating margin expansion medium term. Definitely on track with that, you're up 30 bps last year. You're guiding this year up 30 bps as well. [ph] And I suppose in the round (00:35:02) sort of – should we think about 2021 and 2022 in aggregate being sort of fairly typical when we're looking at the sales trends, understand you've got some price cost noise, but you've also had higher sales growth, and you've guided medium term, so maybe they offset each other? Just trying to understand sort of any big levers good or bad on the margins beyond this year when you think about the medium term or it's kind of steady as she goes and these years are fairly representative in total?

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

A

Yeah, I think, Julian, it's an interesting compare when we think about kind of 2020 being a resiliency cost management time during the pandemic, 2021 being a recovery year, and then 2022, we believe growth will happen but it'll be a lower rate than 2021, which was really was at a much higher base. The big difference in 2022 – and we're not going to release our medium-term outlook till Investor Day on the 15th. The big difference in 2022 is we are kind of back to our core Service growth, 4% to 6% growth, which is supported by the portfolio growing 3%. And as you saw in our guide, that is – obviously, with 80% of our profit, that's where we're going to have 50 basis points of margin expansion in the Service segment.

So New Equipment, a little bit more up and down over the different years, but Service is what continues to sustain us and drive us, and where – we have productivity in both, but that's really what you're going to see as a little bit of preview to Investor Day.

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

A

And keep in mind, Julian, we grew 30 basis points of margin in 2021 after absorbing 50 basis points of mix headwinds, because New Equipment grew much faster.

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

A

3 times faster than Service [indiscernible] (00:36:53).

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

A

Right. So, that's where – so, adjusted for mix, margins are up kind of 80 basis points in the year. So definitely, we are tracking to that 30 basis points that we guided at Investor Day.

Julian Mitchell
Analyst, Barclays Investment Bank

Q

Great. Thank you.

Operator: Thank you. Our next question comes from Stephen Tusa with JPMorgan. Your line is open.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Thanks. Hello.

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

A

Good morning, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Yeah. Hi.

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

A

[ph] Hey Steve (00:37:23), we got you.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Great. Sorry, kind of on the road a little bit here. Just – I guess a simple way to ask the question would be, what [ph] do either of you guys (00:37:35) think is going to be potentially kind of the toughest orders comp in 2022 for China? Should we be kind of ready, for any given quarter just based on where the level is today and what the comps are, for something that is down double digits at any given point for you guys specifically? And then, as a follow up to that, at what level of orders would you need to see this year, given your solid backlog, to have confidence that you can go grow China or at least hold it flat in 2023?

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

A

Yeah, the quarterly order trends are just hard to predict, Steve. By just nature of the orders are – orders are lumpy, right. So that's...

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

A

Maybe, Steve's gone mute.

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

A

...so the orders are lumpy, so it's hard to call out any given quarter, but clearly, as we said earlier the orders grew really strongly throughout and I think, it's – there's a page in the backup that kind of – that has the China orders. So if you go back, and look at kind of our overall China, it was up, kind of 2x. And obviously with stronger growth, a much stronger growth in the first half, and Q4 was still up year-over-year, not as strongly into the first half, but we still outgrew the market even for the fourth quarter, so the compares to the first half are definitely stronger, but as you project forward, and you think about, okay what do we need to drive sustainable growth. China is one factor, and that's clearly important, but keep in mind the rest of our business is growing, it is in very, very solid growth market.

So, if you look at Americas, EMEA, Asia-Pac, and that is about two-thirds of our New Equipment business, so that obviously is in very strong growth markets, so that should help as we go beyond as we go beyond 2022, so that's kind of one. And then, obviously, the second part about this is that the point that Judy made earlier on the Americas backlog, that should help with 2023 as well, because some of the orders that we are not shipping in 2022, those should ship in 2023, so that should help 2023 as well. So overall, we feel confident that we can continue to drive New Equipment up kind of in that low single digit growth range, which was, kind of, in-line with the medium-term expectations. So that is – we stand by that, and I think obviously more to come on Investor Day. And then obviously, to make the point further, with Service growing kind of 4% to 6% this year, and at a very sustainable level that should continue to drive the profit growth into 2023.

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

Yeah, the other thing Steve, we're seeing, and we're sure that you see this in our guide for Service for 2022, but it's going to keep growing as the monetization business. So we show that it's 4% to 6% for 2022, but we're going in with the 6% backlog there, great orders performance in the fourth quarter especially in Europe and the Americas where the bulk of that is so that's going to continue on into 2023 as well.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC Q

Got it. I mean, just one last one for you. I mean, in your guidance, how much of the year-over-year is that driven by like some of the more Otis specific initiatives around productivity that you've been banking – hitting on for the last couple of years since coming public.

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

Yeah, a lot of that, Steve, I mean, if you look at, kind of, if you look at our profit guide, it's largely a volume story. But we have commodity headwinds of $90 million that we're largely offsetting through our productivity initiatives on the New Equipment side. Overall, on the pricing side of New Equipment are the margin drag that we have from backlog margins being down is being offset by in-year pricing improvement. So that helps, but we offset as commodity headwinds by productivity actions on both material and installation. And on the Service side, we're not talking about wage inflation headwinds into our guide because the productivity that we're driving in the Service side is offsetting that. And Service profit is driven by volume and pricing, right, which was up 1% last year and is obviously trending in our favor.

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

Yeah, and on the Service pricing, I'll just amplify a little, I mean really good performance in Europe which is where 1.1 million of our 2.1 million units are, and the Americas; so those two make up the bulk of the portfolio. We got a – we got to a point in 2021, we're expecting that much in 2022 on price. And Steve, we'll know most of that in the first quarter because that's when most of our renewals happen.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC Q

Great, thank you.

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

A

Thanks, Steve.

Operator: Thank you. Our next question comes from John Walsh with Credit Suisse, your line is open.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi, good morning.

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

A

Good morning.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, maybe just a couple of quick clarifications for me. I just want to make sure on comparing things apples to apples here. But can you remind us what you're exactly forecasting on that industry New Equipment growth slide there on slide 5. Is that a kind of a units number? Does that include price? Just would love to get a little more clarity on that.

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

A

Yeah, that's the units number. That's the easiest way for us to make a global compare.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Got you. Great, that's what I thought. Okay. And then, maybe just on really strong share gains this year 115 basis points on top of the 60 basis points you said there, we can see that chart in China where you're up growing the market. Can you give us a little bit more color on where some of the other market share gains are coming from broad-based or any geographies you'd call out?

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

A

Yeah, it's broad-based, John, especially this year. We've seen – we've seen Asia-Pacific especially in both the mature markets. But in India, which is really starting has come back strongly as a large segment. We've seen that come back very nicely in 2021 in terms of share gain. And – but it's broad-based. I would tell you that Europe, obviously lots of different countries, but Western Europe we did well. And again, I'd call out some of the ones in Asia-Pac ex-China, China's done incredibly well.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Great, I appreciate you taking the questions; I'll pass it along, thank you.

Operator: Thank you. Our next question comes from Cai Von Rumohr with Cowen, your line is open.

Cai von Rumohr
Analyst, Cowen and Company

Q

Yes, thanks so much and good results. So, thank you for – you broke out, I guess, the China risk, 10 customers, 2% to 3% of China sales. But what is the risk if they have crossed 2 to 3 red lines that basically they stopped paying that that morphs into a bad debt risk.

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

A

Yeah, no, it's a good question, Cai. And really if you look at our overall China business, we have done really well. I mean, our cash flow in China was very strong. [indiscernible] (00:44:53) it was well above 2020 levels. We've been – and a lot of that is working capital, I mean receivables that are up kind of call it less than 10% on 25% revenue growth in China. So, our China business did really, really well on cash management. But having said all that, obviously, the situation needs to be managed very carefully, and we're dealing with on a customer-by-customer basis. As the chart at the back says only 2% of our customers in China that are in the orange or a red-line category are at credit risk. And we've tightened the terms where the situation is warranted, but we don't feel we need to make any wholesale changes there.

And if you look, on a company, overall 2021, our bad debt expense in 2021 was actually lower than our bad debt expense in 2020 despite 9% higher revenue. So we managed the situation well and we'll definitely keep an eye out for 2022.

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

A

Yeah, the only other thing I'd add, Cai, is when we look at a broad-based group of developers inside China, we do a significant amount of business in our key accounts with the SOEs and the state-owned property developers who really have stronger financing advantages, they are gaining more share. And as Rahul said, we're managing this – our China team is managing this on a daily basis with a lot of discipline and rigor. So we're pleased with our bad debt, how we ended 2021 as he said. But we're also understanding and watching closely where the market's going, and when needed, we're moving to all-cash prepayments to protect our own balance sheet.

Cai von Rumohr
Analyst, Cowen and Company

Q

Thank you and the second question, so you mentioned that you've installed 100,000 Otis ONE units last year. What is the plan for this year, and basically as you install more units, I think you've made the point that because you have a bigger share of the overall service population of the world, your takeaway opportunity is greater than others? Talk to us a little bit about what you are seeing in terms of service takeaways too.

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

A

Yeah, so we did 100,000 units in 2020, we added another 100,000 units in 2021. It will be comparable in 2022 as we get to that 60% coverage level in the medium term, and there is good reason for that, some of it is our portfolio – our service portfolio is not all Otis units, and we focus, we started this by focusing on Otis controllers where we had the most knowledge, and the best technical solution, we're now expanding that.

But there's also some old controllers out there as many of you know, and some very old elevators that don't make sense to connect. So we think we're on a good half, because what it's doing Cai, is it's driving that stickiness that we want with customers. So it's giving us more productivity, but it's giving our customers real value to be able to see the heartbeat of their elevator in their Otis ONE App, to understand if it's running or not, whether they are on site or not. And so, we think it's really helped our retention rates which now, as Rahul said in his remarks, are over 94%, which is leading in the industry. And it's also helping our conversion rates because last year we introduced – in 2021 we introduced our Gen3 portfolio across the globe and Gen360 in certain countries in Europe.

And those all come prepopulated when we ship them with Otis ONE out of our factories now depending on where you're in the world in certain factories. So it's already, it's leaving the factory with Otis ONE installed. So our customers actually seeing the benefit of this during the warranty period and that's, especially in China, helping us on both the portfolio growth, and the conversion that Rahul talked about which is now at 45% for the year.

So we've moved up five points in China on our conversion rate and that's the stickiness we're getting everywhere in the world. Any time we're more connected with our customers, we get that stickiness which will again have that compounding effort of growing our portfolio.

So, great productivity for us, which supports our margin drop-throughs and our incrementals, especially on volume and service this year that's driving the 50 basis points of margin expansion. But most importantly, it's getting that royalty and stickiness.

Cai von Rumohr
Analyst, Cowen and Company

Q

Thank you.

Operator: Thank you. Our next question comes from Nick Housden with RBC Capital Markets. Your line is open.

Nick Housden
Analyst, RBC Europe Ltd.

Q

Yes, hi everyone, thank you for taking my question. You mentioned that you grew at double the market rate in China in 2021, which is a really impressive result. I am just wondering what the main drivers of this actually were? And just how sustainable it is? I mean, was it the case of just picking some low-hanging fruits or is it something that we can expect to continue for a few years, thanks.

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

A

Hey, Nick. It's absolutely execution of the strategy that we put in place just before and that's been for our growth in China. We expanded our agents and distributors to give us greater sales coverage and reach. We're now at 2,200, and for those of you who were kind of keeping count by quarter, that's because we're pruning the ones that weren't performing as well. But we think we're at a really good place, we've had growth in the quarter in Tier 1 and Tier 2 cities. Actually, we've seen that all year in China as well as the growth in infrastructure and growth in the industrial segments in the fourth quarter, which is really strong. So, we grew sales coverage that's one piece.

The second is we continue to increase our focus on key accounts. And those key accounts want a national provider and they want to keep us for our service. That's helping with our conversion rates and our retention rates. And a lot of those key accounts are state-owned enterprises. I know people don't typically think that way, but it's important as we watch what's happening in development in China right now that we keep that balance between private and SOEs. So, we've been able to do that.

And then, we've just really enhanced our relationships. We've continue to innovate. We brought Gen3 to market in China first, in the middle of last year, and we were able to sell in the thousands there. And we expect Gen3 actually, globally, to be about 20% of our shipped units here in 2022. So, combination of coverage, focus on key accounts especially in Tier 1 and Tier 2 cities because we were under share there, and then bringing innovation and new product to market. And that's been the strategy our team is executing, and we expect continued share growth regardless of if there are headwinds or some fluid situations.

Nick Housden
Analyst, RBC Europe Ltd.

Q

Thanks, that's very clear. And just kind of following on from that, so, obviously you're taking share in China which is great, are you taking it from the other global OEMs or is it mostly the local players who are losing out here?

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

A

Yeah, that's hard to say, Nick, exactly, I think we'll have others report as well. What we really know well is how the market grew and how we grew against that. So, those – that data is published, we have some external agencies that kind of track that. So, we know our performance well. I think as other companies report [ph] there's going to be a (00:52:40) little bit more clarity on that. But it's hard to say exactly what's – where the share gain is coming from.

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

A

Yeah, same with Service. It's just hard to say.

Nick Housden
Analyst, RBC Europe Ltd.

Q

Okay, thank you very much.

Operator: Thank you. Our next question comes from Joel Spungin with Berenberg. Your line is open.

Joel Spungin
Analyst, Joh. Berenberg, Gossler & Co. KG (United Kingdom)

Q

Hi, there, good morning. I just wanted to pick up on something I think, Rahul, you mentioned in your prepared remarks around pricing. I think you said you still in the quarter came out better than you've been expecting. I was just wondering if you could may be just elaborate a little bit on that, maybe why that was. And if you have any sort of thoughts or remarks about sort of pricing in the wider industry, that would also be helpful.

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

A

Yeah, my comment, Joel was with regard to New Equipment pricing, and it was marginally better than what we had expected. So, Asia where the course to the booking timeframe is short, we saw meaningful improvement on our booked margin trends both versus last year, and we saw sequential improvement versus the last quarter as well. So, that is where a lot of improvement in the quarter came from.

EMEA was largely flat over last year. America's margins were down year-over-year. Part of that was mix in the orders, but we did not expect any improvement in Americas, so, Q1 of next year, given the course to the order cycle; and – but we did see sequential improvement from Q3 to Q4 in the year-over-year trend, and that's encouraging. And we expect additional improvement as we go into Q1 of 2022. So, that is where that was the overall flavor on the booked margin trends. And then Service pricing, as we said, that was up about 1 point in the quarter largely driven by Americas and EMEA.

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

A

And Joel, the only place really we're seeing the intense competition is really in the infrastructure segment. And we get to see that more because most of those are public bids. But those are the volume infrastructure that people are looking at, both in Europe and in Asia. And that's really where we're seeing kind of the more competitive pricing. We're not – we haven't seen any of the pricing in China to where it went after 2015 with precipitous drops, haven't seen any of that yet. It's competitive, as you would expect, but really mainly seeing it in the infrastructure segment.

Joel Spungin
Analyst, Joh. Berenberg, Gossler & Co. KG (United Kingdom)

Q

Okay, that's helpful. Thank you very much. If I can just ask one more thing, which is just with regards to the comments you made on the slide deck at the back about China pricing in – or sorry, the Chinese market in Q4 being a little bit better than perhaps you'd expected. I'm just trying to sort of marry that with your remarks about the outlook for China which it feels like I think your previously Q3 talking about a flattish market in China in 2022. And I think [ph] you're now talking about as you're down (00:55:36) mid-to-high single digit. How do we reconcile those, do you think? Are you actually seeing in, maybe some of your early indications, for bids in China going into this year that there is already been some weakening in terms of the level of activity, I mean even allowing obviously for harder comparators?

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

A

Yeah so what we – for China – China market was stronger than what we had anticipated all through 2021. We started the year in 2021 thinking the market's going to be up kind of mid single-digits. It was up 10% as now we're seeing. Even going into Q4, we thought the market would be down but it ended up being flat. So, the market continue to surprise us on the upside. And if you look at some of the underlying trends in the China market, the floor space under construction was up 5% in 2021. It's above – 8% above 2019. The real estate investment was up in the year as well in 2021, that was up about 4%. And historically, these trends have a high degree of correlation.

But where the weakness comes from, Joel, is if you look at the new starts, they were down about 11% in 2021. So, that is where – so the real estate investment is up, floor space under construction is up, but the booking starts are lower. And that is where I think is good to guide [indiscernible] (00:56:56) everything that we're reading in the market is the market could be down. So, I think we're guiding to 5% to 10% down. Obviously, that is still a fluid situation. We are seeing the support from government starting to kick in, both from the central government and from the local governments. Central government in the form of mortgage loosening, some flexibility around the Three Red Lines policy, increase in money supply. So, all those things are happening. And even with the local governments that rely on land sales for a big portion of the budgets, we're seeing some support from them as well.

So we're kind of seeing a mixed picture, but I think it's good to say it's down 5% to 10%, calibrate our revenue accordingly, and then if it's better, that's a lot better situation to be in than be surprised on the downside.

Joel Spungin
Analyst, Joh. Berenberg, Gossler & Co. KG (United Kingdom)

Q

Okay, thank you very much.

Operator: Thank you and that's all the time we have for questions. I would like to turn the call back to Ms. Judy Marks for closing remarks.

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

Thank you, Kathryn. So to summarize, 2021 was an excellent year for Otis. We executed on our four strategic pillars, introduced innovative new products, made good progress on our ESG initiatives, and demonstrated the strength of our capital management strategy.

Our colleagues made all of this possible, delivering for our customers, passengers and communities globally. The fundamentals of Otis and our industry remains strong, and we're well-positioned to deliver on our 2022 financial outlook including high single-digit EPS growth and approximately $1.6 billion in free cash flow.

We look forward to speaking with you at our Investor Day on February 15th to share more about our strategy and medium-term growth outlook. Thank you for joining us today. Stay safe and well.

Operator: This concludes today's conference call. Thank you for participating. You may now disconnect. Everyone, have a great day.

Editor's Note: The word in the [] was added as a request from the client after the conclusion of the call to provide better clarity.