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Otis Worldwide Corp. (OTIS)

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to Otis Third Quarter 2020 Earnings Conference Call. Today's 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 will 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, Sonia, and good morning, everyone. Welcome to Otis' Third Quarter Of 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 or 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 if Otis was a stand-alone company in the current period and the 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 and quarterly report on Form 10-Q provide details on the 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.

Thank you, Stacy, and good morning, everyone. Thanks for joining us and we hope that everyone listening is safe and well. To start, I want to thank each of our colleagues around the world for their unwavering dedication as we continue to deliver on our commitments to passengers, customers, and shareholders.

Overall, as you'll see in our results, our business is trending back towards pre-COVID levels, improving sequentially across all metrics. I'm pleased to share that we had a very strong quarter. We gained share in new equipment, paid down debt, and are raising our outlook with Rahul providing additional details. Our strategy is robust despite the unique environment we're in, and as an example of our ability to continue to execute, this quarter, we completed the acquisition of Bay State Elevator, expanding our scale and density in the Northeast United States. We're delighted to have the Bay State colleagues join the Otis team. And we remain focused on accelerating growth of the service portfolio, both organically and inorganically. Our bolt-on M&A strategy is working and serves as an accretive source of growth.

Innovation is core to Otis. COVID accelerates the need for new health and safety solutions which we expect to continue post-COVID. Otis is a leader in this space, continuing to bring new products to market. And during the quarter, we commissioned an elevator airflow study, examining the risk of airborne transmission in elevators, and how to best mitigate those risks through science-based safety protocols. The study is being led by a Purdue University expert in the spread and prevention of infectious disease through indoor air systems. We look forward to sharing these findings in the coming months.

Furthering our ability to provide innovative cutting-edge products, we opened a new Industry 4.0 Escalator factory in East China that incorporates intelligent manufacturing, advanced automation, and digital technologies such as 3D modeling, custom engineering, and real-time quality management. This move continues to rationalize our footprint and build on our legacy of excellence while upgrading our smart manufacturing capabilities for a new era.

We continue to deploy iPhones to our field professionals, adding four more countries during this quarter, and the adoption of our suite of apps continues to expand, driving service productivity within the organization. In addition, our IoT deployment continues to build momentum and we have plans in place to enhance the capability of Otis ONE solutions over the next several months to drive productivity in our organization. Despite the challenges introduced by the pandemic, we continue to deploy these units in the US, Europe, and China during the first nine months and expect the pace of deployment to accelerate.

Otis also received several key orders across each of the regions highlighted on slide 3. In Chicago, we received an order to outfit the new Salesforce Tower Chicago office building with over 30 SkyRise and Gen2 elevators. Each of the passenger elevators will have our new innovative Compass 360 dispatching system, allowing for seamless travel in a 60-story building. In China, Otis was selected to support Tianjin's metro expansion project. We'll add approximately 120 elevators to Line 6, bringing the total number of Otis elevators and escalators throughout the Tianjin metro to approximately 1,400 units.

This award extends Otis' involvement in infrastructure development in the region, a key strategy for us. And in France, we're helping bring La Defense, the business area of Paris to new heights with an order to deliver 60 elevators and several escalators to The Link, the next tallest building in France. This project will include CompassPlus, eCall, and OptiSense technologies, creating a faster, safer, and more seamless trip for the passengers. These are just a handful examples that led to the approximate 70 basis points of new equipment share gain during the first nine months.

In terms of liquidity, we ended Q3 with $1.7 billion of cash and continue to maintain a revolving credit facility, which serves as a backstop for our commercial paper issuances and an additional source of liquidity if needed. We also made progress on our debt repayment goal of $350 million in 2020, repaying $250 million in the quarter.

And as we remain dedicated to delivering results for our customers and shareholders, our commitment to global corporate citizenship has not wavered. Last quarter, I shared with you the launch of 'Our Commitment to Change'. In just three months, we've begun to make Otis a more diverse, equitable, and inclusive culture and identify and prioritize actions we need to take to get there. For example, in the quarter, we enlisted an outside diversity equity and inclusion expert to independently assess our practices and provide recommendations to guide future decisions and programs. Later during the quarter, we launched 'Made to Move Communities', a CSR program focused on advancing youth STEM education and providing inclusive mobility solutions for communities in need. This extends Otis' ongoing commitment to the communities, where we live and work, and we look forward to providing the avenue and resources to help young minds explore new ways to give people freedom to connect and thrive in a taller, faster, smarter world.

Turning to slide 4, Q3 results and 2020 outlook. New equipment orders were up slightly at constant currency with low single-digit growth in EMEA and Asia, partially offset by low single-digit decline in the Americas. China orders were up high single-digits as the business continued its rapid recovery from the impacts of COVID-19. On a rolling 12 months, total Otis orders were down approximately 1%. New equipment backlog continued to grow, up 3% versus the prior year at constant currency. In the third quarter, organic sales were down 1.2% with the new equipment segment down 1% and the Service segment down 1.4%. Adjusted operating profit was up $33 million and margin expanded 120 basis points, driven by continued expansion in the service segment on strong contribution from productivity and the benefit from cost containment actions and favorable transactional foreign exchange. Free cash flow was robust at $311 million with 117% conversion of GAAP net income.

While there remains uncertainty around the global recovery from the pandemic, we are encouraged by these strong year-to-date results and the trends we're experiencing, giving us confidence to revise our 2020 outlook. We are improving the organic sales range, now expected to be down 2% to 3%. Adjusted operating profit is now expected to be in the range of up $30 million to $40 million, a $60 million improvement versus the prior outlook at the midpoint. We now expect adjusted earnings per share to be approximately $2.42, up $0.17 versus the prior midpoint. This reflects our improved adjusted operating profit outlook, lower adjusted tax rate, and lower net interest costs. Lastly, we expect free cash flow to be robust at approximately $1.15 billion with full year free cash flow conversion at approximately 135% of GAAP net income.

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

Rahul Ghai

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

Thank you, Judy, and good morning, everyone. Starting with third quarter results on slide 5. Net sales were $3.3 billion, down 1.4% with a 1.2% decline in organic sales. As anticipated, both the new equipment and service segments declined organically, primarily from the impact of COVID-19. Adjusted operating profit in the quarter was up approximately 7% or $33 million and up $30 million at constant currency as the impact of lower volume, temporary price concessions, and field inefficiencies was more than offset by strong productivity, cost containment, and favorable transactional FX. Our focus on reducing material cost continues to yield results and maintenance hours per unit sustained a downward trajectory.

Cost containment efforts that we launched in Q1 of 2020 also helped alleviate the pressure from lower volume and year-to-date SG&A expense was down by more than $60 million year-over-year. At the same time, we continued to invest in the business and R&D expense as a percentage of sales was about flat versus the prior year. Our strong focus on operational execution drove 120 basis points of adjusted margin expansion with continued margin improvement in the service segment. Third quarter adjusted EPS was up 25% or $0.14 from $0.06 of operating profit growth and the balance from a lower adjusted tax rate and a drop in interest costs. These results were better than we had expected in the previous outlook, driven by the stability of the maintenance business, higher savings from service productivity, and progress on reducing the adjusted tax rate.

Moving to slide 6. New equipment orders were up slightly at constant currency and were down approximately 1% on a rolling 12-month basis. Order intake continues to outperform the market and we gained approximately 40 basis points of share in the third quarter in a market that was down low single-digits. Booked margins were up slightly in the quarter and were flat year-to-date versus the prior year. In the quarter, booked margin improvement in China and North America was partially offset by pressure in parts of Asia Pacific and EMEA. New equipment backlog was up 3% at constant currency driven by growth in the Americas with overall backlog margin improving slightly from Q2 and remaining stable versus the prior year. New equipment organic sales were down 1% as mid-single-digit growth in China was more than offset by declines in Asia Pacific and parts of EMEA.

At constant currency, new equipment adjusted operating profit was down $9 million and margin contracted 50 basis points as strong material productivity and cost containment was more than offset by the impact of under absorption, field inefficiencies, and an unfavorable mix. Service segment results on slide 7 remained strong in the quarter. Number of units under maintenance contract increased by over 1% with growth in all major regions and China up more than 6%. Modernization orders were down 7.3% at constant currency as double-digit growth in Asia driven by the mandated regulatory upgrades in certain markets was more than offset by lower order intake in the Americas and EMEA.

Service organic sales were down 1.4% as maintenance demand remained strong while discretionary, repair, and modernization projects were pushed out. At constant currency, adjusted operating profit margin expanded 140 basis points and profit grew $19 million as strong contribution from productivity and cost containment actions more than offset the impact from volume decline, temporary price concessions, and an increase in bad debt expense. The service pricing environment, excluding the impact of these price concessions, was about flat. Overall, year-to-date results reflect solid performance with $33 million of adjusted profit growth at constant currency and 90 basis points of margin expansion despite organic sales being down 3.3% versus the prior year.

The service business was particularly resilient with adjusted operating profit growth of $47 million at constant currency on a slight decline in organic sales in an extremely challenging market environment. Also, third quarter results reflect sequential improvement in both segments and steady progress towards returning to pre-COVID levels. Access to job sites and buildings has largely returned to normal outside of India and Southeast Asia and the service call volume is back to 2019 levels in China and Asia Pacific, and the trends are heading in the right direction in Europe and Americas. We are improving our 2020 outlook to reflect strong progress during the year and these encouraging trends.

Turning to slide 8. We now expect overall organic sales to be down 2% to 3% for the year, up from prior expectations of down 2% to 4%. With the improvement in both new equipment and service segments, we now expect new equipment sales to be down mid-single-digits and service sales to be flat to down slightly. Adjusted operating profit is expected to be up $30 million to $40 million at constant currency for the year with 60 to 70 basis points of margin expansion. This is an improvement of $60 million versus the prior outlook at midpoint, reflecting the strong year-to-date performance, benefit from an improved sales outlook, and higher service productivity. At actual currency, adjusted operating profit is expected to be up $5 million to $15 million, reflecting favorable foreign exchange trends in addition to the operational improvement.

Adjusted EPS is now expected to be up 8% versus the prior year to approximately $2.42 and up $0.17 versus the prior midpoint. Driven by an improved operating profit outlook, lower net interest cost, and a reduced tax rate, we now expect the adjusted tax rate for the year to be about 30.5%, down 1 point versus the prior outlook.

Taking a further look at the organic growth assumptions on slide 9. In the new equipment segment, Americas is now expected to be down mid-single-digits, reflecting strong recovery in the third quarter with sequential improvement and year-over-year growth in the fourth quarter. EMEA is now expected to be down mid to high single-digits, reflecting a strong recovery in Northern and Eastern Europe. We are improving the Asia outlook driven by better-than-expected third quarter performance in China. However, we expect Asia to be down in the fourth quarter due to continuing challenges in India and Southeast Asia.

In the service segment, we expect the maintenance and repair business to be flat to down slightly with the maintenance sales remaining resilient and a slower recovery in discretionary repairs. We are raising the modernization outlook to be about flat for the year, driven by better-than-expected performance in Asia Pacific from an effective go to market strategy to tap into the demand created by regulatory requirements. Overall, the outlook of 2% to 3% organic sales decline reflects sequential improvement and return to pre-COVID levels in the fourth quarter at the midpoint.

Switching to operating profit on slide 10. At constant currency, operating profit is now expected to be up $30 million to $40 million versus the prior year, reflecting the benefit of solid contribution from material and service productivity and cost containment actions that are more than offsetting the impact of reduced volume from the COVID-19 pandemic, incremental under absorption of costs, and temporary price concessions in the service business. This represents a $60 million improvement versus the prior expectations. With improvement in both new equipment and service segments.

The fourth quarter outlook includes incremental investments in the new equipment and service sales channel in China, additional cost to complete the maintenance visits, sequentially higher R&D expense, and the expected step-up in public company costs. Foreign exchange is now expected to be a headwind of approximately $25 million, an improvement from a headwind of $40 million to $50 million that we had expected in July primarily due to strengthening of the Euro against the US dollar.

An update on capital deployment on slide 11. We started 2020 with about $1.4 billion of cash and now expect to generate approximately $1.15 billion of free cash flow in 2020. An improvement of $100 million versus the prior midpoint from higher net income and an improved working capital performance. As Judy mentioned, we repaid $250 million of debt in the quarter with another $100 million of repayment planned for Q4. We also refinanced $500 million of the US term loan for a Euro-commercial paper program, our first foreign currency-denominated debt transaction, as we continue to evaluate our capital structure. We still expect to return $260 million to shareholders through dividends in Q2 to Q4 and spend approximately $200 million between non-controlling interest and M&A.

These actions will allow us to maintain sufficient liquidity and position us to increase cash on the balance sheet by the end of the year, giving us optionality depending on the overall liquidity conditions to start share buyback in 2021 after we complete the previously disclosed $500 million of debt repayment.

With that, I'll turn it over to Judy for closing remarks.

Judith F. Marks

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

Thanks, Rahul. I'm pleased with our year-to-date performance, navigating continued COVID challenges, while continuing to drive our long-term strategy, all in our first year as a stand-alone company. In early 2021, we'll provide an update on our 2021 and medium-term outlook. We continue to expect sustainable growth and global share gain and are seeing traction with new equipment share, up approximately 70 basis points year-to-date. This growth will continue to feed our leading service portfolio, where we remain focused on service transformation initiatives, deploying IoT and digital tools that drive value for our customers, productivity, and margin expansion. We'll remain committed to driving value for our shareholders, driving EPS growth and robust cash generation, all while investing at sustainable levels to position us to stay at the forefront of this industry.

With that, I'd like Sonia to open up the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from Carter Copeland of Melius Research. Your line is now open.

Carter Copeland

Analyst, Melius Research LLC

Q

Hey. Good morning, everybody.

Judith F. Marks

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

A

Good morning, Carter.

Carter Copeland

Analyst, Melius Research LLC

Q

Just quick ones. One, the Bay State acquisition, did that add any meaningful amount to the service portfolio growth you talked about in the Americas? And then just as a follow-up, on Otis ONE and pricing, pricing differentials you've seen on those connected units or what your expectation is for those in the future, just high-level thoughts on that would be appreciated. Thanks.

Judith F. Marks

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

A

You bet. So, Bay State, again, pleased to have them joined the Otis family, but that is not material in terms of what contributed to the portfolio growth in the Americas, specifically in North America for the quarter. In terms of Otis ONE, we are ramping up and accelerating our deployment. We've seen productivity gains. But in terms of additional subscriptions or revenue, it's still early in terms of where we're able to gain traction on that. It's certainly adding value and productivity. We've seen that in China. We've seen it in Spain. And we're now seeing it and hearing from our mechanics in North America in terms of how it's giving them the ability to show up quicker, to have less running on arrivals when they get there because they know it's already running on arrival and they don't have to actually make that service call. So, we're pleased with the early results, but it's not anything that's really added to the top line in terms of subscription revenue yet.

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

A

So, just to add to that, Carter. Otis ONE joined the suite of other connected applications that we have like destination dispatch system, elevator management system. And those applications combined add about 30% to 40% of the subscription revenue. So, as Judy said, our first focus on Otis ONE is productivity and we do feel the benefit to the customers both in terms of visibility and better uptime that we can provide will start adding incremental and additional revenue over time. And we see that in Asia and other parts of Europe, where we do have a remote service capability that we provide through even the phone lines. We are able to get incremental price on those units. So, it will help over time, but our first focus has been productivity on Otis ONE as we've previously stated.

Carter Copeland
Analyst, Melius Research LLC

Q

Great. Thank you for the color. I'll let somebody else ask.

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

Steve Tusa
Analyst, JPMorgan Securities LLC

Q

Hey, guys, good morning.

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

A

Hi, Steve.

Steve Tusa
Analyst, JPMorgan Securities LLC

Q

So, just first of all on the kind of new equipment guide for the year. It just looks like you kind of took up the high-end of the range for some of those or at least moved those higher at the high-end and you really don't want to be removing the low end of the range. Is that just kind of some rounding error around some of the region? It just seems like maybe that that total number should've moved up a bit more.

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

A

Steve, you're right. I mean, we did kind of looked across all the regions, and we have improved the bottom end of the range, and down from mid to high single-digits to down mid-single-digits. And keep in mind, we're down 5% to 10% on the Q1 call. So continued movement in the right direction and the outlook has improved kind of across all the regions, strong performance in Q3, especially in China and the Americas. And at the mid and the high-end, we have growth planned for Q4. So, there could be some rounding because I think we don't give specific ranges. So, I think we can – you can take that offline if there are certain questions. But overall, we feel really good about the way the business is moving and we do expect growth in EMEA and Americas at the mid and the high-end of the range. So that's we feel good about that item.

Steve Tusa
Analyst, JPMorgan Securities LLC

Q

And then, just listening to some of these other guys, I mean, Kone, Schindler, and you guys are all talking about intense price pressure and I think Schindler mentioned pricing like 50 times in its presentation or something like that, using round numbers. Yet you guys are saying that your book margin was actually okay in the quarter. Can you try and reconcile like what you're seeing financially in your orders and your business? Is it something in the pipeline that you guys all see that is sneaking up on you from a price perspective? It's just going to be a matter of timing or is that just, hey, this is COVID, things are flying around where it's uncertain. So, we just don't want to make any price, promises on price. Because it just seems like there's a lot more high-level caution around price, but I don't really see it in orders or the numbers. Can you just kind of help reconcile that?

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

A

Yeah, so, Steve, in the third quarter, we saw better volumes. Our productivity remained strong and our pricing held. Our orders were up slightly and you said it, we're up 20 basis points in booked margin and really pleased with that improvement especially coming after the second quarter where we had 70 basis points going the other way and we grew our backlog, so every 3% [ph] when we're going with (00:26:45) 3% up in backlog. So, while we're seeing the markets competitive, pricing was competitive in the third quarter, we would tell you the place that was most competitive was in North America. But we are seeing, we had low single-digit gains (sic) [order growth] in terms of EMEA and Asia. High single-digit gains (sic) [order growth] in China and low single-digit we were down in the Americas. So, so far, we're dealing with what we can control which is winning the business, growing the share, we grow at about 40 basis points, and then executing on that backlog by driving as much productivity and cost control as we can. And this backlog, by growing, is really going to feed our 2021 and put us in a pretty good position there. So, we were pleased with what we saw Q3 versus Q2 and all the sequential improvements. But I would tell you it's getting more competitive certainly in North America on pricing.

Steve Tusa
Analyst, JPMorgan Securities LLC

Q

And then to...

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

A

Steve, just I just want to – just maybe a couple of points to add to what Judy said. Our year-to-date booked margins were flat, right. So, that's kind of – that's a good thing, okay. First quarter was up, second quarter was down, third quarter was up. So year-to-date, the booked margins are flat for the nine months of the year. And the other point is our backlog is up and the backlog margins are sequentially better than Q2 and flat to last year's. That goes back to the comment that you made on the pipeline, right. I mean, so our backlog margins which will drive revenue for next year, those margins are flat. And again, we do – this is the story we've been saying since our kind of our Investor Day that we do expect tough pricing environment. We've expected it. Obviously, the macro economic conditions are not great. But the focus that we have on driving productivity and the fact that we've been hitting our 3% target now for nine months and constantly we're going to hit for 12 months and that focus is unwavering. So, we'll continue to improve our execution installation, our maintenance productivity, and if there is pricing pressure, we'll find a way to offset that.

Steve Tusa
Analyst, JPMorgan Securities LLC

Q

One last quick one for you guys. We're all trying to kind of learn how to compare all these companies over time. And I guess you guys define share gain differently. These companies, your competitors say different things about the markets. When you guys talk about your kind of market share and how you're competing, are you looking at like very high-level numbers versus the Schindlers and the Kones of the world, or are you saying within our specific verticals that's kind of how we analyze it because that obviously would explain why it's not directly necessarily like a one-for-one read from a Kone or a Schindler, or are you looking kind of high-level globally and you're not really paying attention to fighting with those guys and across the different verticals, like residential, commercial, infrastructure, et cetera?

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

A

Yeah, so when we talk about share, Steve, we talk about how we have done versus the market. So, again, I think Kone and Schindler report and the other companies that don't, so you don't know who exactly we're gaining share from. But the fact is when we compare our orders, we know that we've outgrown the market and that's how we compare it. So, if you look at, you're flat for the quarter, down 1% on a rolling 12-month basis and obviously, in this environment, the market we know is down more than 1% on a rolling 12-month basis. And we are down about 2 points year-to-date. So, that's a fairly strong performance given the environment. And so, based on the analysis that we do, we believe, as Judy said in her prepared remarks, that we think we've gained about 70 basis points of share and that has allowed us to grow our backlog by about 3 points.

Steve Tusa
Analyst, JPMorgan Securities LLC

Q

Great.

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

A

Yeah, Steve, we task every one of our countries to beat share in – to grow share in their country and that's going to continue through 2021. So, we do look at it at a pretty finite level.

Steve Tusa
Analyst, JPMorgan Securities LLC

Q

Great. Thanks a lot. Appreciate it.

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

A

Thanks, Steve.

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

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi, good morning.

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

A

Good morning.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

Hey, maybe just the first question around the orders outlook in new equipment. So, you're sort of flattish in the third quarter, globally down a touch on a trailing 12-month basis. When you look at the overall environment, do you think that this is kind of a status quo level that you're at now for the foreseeable few quarters? Maybe there's some regional differences, so Americas gets a bit better, but then you start to see China rolling over as comps get tougher. Maybe just help us understand how we should think about orders for the next couple of quarters.

Rahul Ghai

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

A

Yeah. So, Julian, it's hard to comment, right. I mean, it's hard to comment on the orders [indiscernible] (00:31:33) We're pleased with the performance we have year-to-date, and go back to what we said from the last call that, for 2021, our priorities were that we wanted to end the year in a strong backlog position, and being up 3% year-to-date, obviously, gives us a lot of confidence. And what we want to do to take it up a step further, our next step obviously is the fact that we want to accelerate the backlog conversion for 2021, and that gives us confidence to grow our new equipment business and not have the volume-related headwinds that we've had this year. So, that's kind of our focus for driving new equipment revenue next year.

In terms of the market, I think Judy can comment as well but the picture is mixed. I mean the fact that we're seeing a pretty – we are seeing a sharp bounce back in China. The other markets are a little bit softer as you would expect. And the projections are a little bit harder. Based on the data we are seeing, there's a little bit of a snapback in Asia and in China, and Europe looks okay as well. North America is a little bit more mixed, but we'll see where that goes, but what we are focused on is kind of driving what we can control. And the other point I want to make up is our proposal activity, our proposal activity year-to-date is up double-digits, and that goes to all the things that we've been saying we are going to do in terms of expanding our sales coverage, adding more salespeople. We've added more to the 100 salespeople year-to-date, added 700 more channel partners in China. So, that is able – that allows us to, even in a down market, increase our proposal activity. And, hopefully, that means well for our orders to come.

Judith F. Marks

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

A

And, Steve – oh, I'm sorry, Julian, let me just add one item. We've really tried to take a hard look the past few weeks or months or certainly starting into this quarter with the rebound of COVID cases, are we seeing any changes? We're still continuing to see new starts in Europe. We're cautious in North America especially on non-res but the Asian economies have turned the corner and China is accelerating and we expect growth next year in the China segment.

Julian Mitchell

Analyst, Barclays Capital, Inc.

Q

Thank you very much. And then maybe my second question around the cost and profit outlook. So, looking at slide 20, the stand-alone costs guidance for this year has come down about $20 million versus the prior guide but the run rate on stand-alone costs is unchanged. So, I was trying to understand does that mean that we get a step-up in those costs shift in the P&L as we see it – of that sort of $40 million-ish number into next year or am I misreading it? And then also, the separation costs, I think those were close to $30 million in Q3. Did those separation costs abate in the fourth quarter or do we still get some into next year?

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

A

Yeah, no, all good questions, Julian. So, on the – so, we've been like focused on producing our SG&A, right, indeed. So, that right since Q1 and obviously driving the $60 million reduction year-over-year is fantastic. And you see some of that coming through lower public company cost, and that's a good sign. We don't have a 2021 number yet. We didn't want to update you guys on one – one number for 2021 versus providing the context and the framework for how everything else will be. So, again, our goal is to not get to $175 million but we will provide more color and more guidance as we talk about the rest of 2021. So, more to come on that. But good news that we're able to instead of being at $150 million, we are $130 million for this just shows you the focus and the discipline that we had inside the company. In terms of stand-alone costs, and separation costs, I think, our number is $140 million to $170 million. That's the number we had said and that's largely between this year and Q1 of next year. I think we'd be tracking to that. I think the year-to-date number is around $85 million so that's between $80 million and $85 million. So far, the rest between Q4 and Q1, and that will be the end of that separation cost.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Perfect. Thank you.

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

A

Thank you, Julian.

Operator: Thank you. And our next question comes from Jeff Sprague of Vertical Research. Your line is now open.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners, LLC

Q

Thank you. Good morning, everyone.

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

A

Jeff.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners, LLC

Q

I wonder if we could focus a little bit more, picks up on a couple of the earlier threads but kind of how and where you're competing. And what I mean by that is in addition to Kone and Schindler which we can all see, right, there's probably and other competitors that really matter. But interestingly in the quarter, right, it does seem your orders did not grow nearly as much as they did, but your total orders on a global basis actually matched them. Obviously, there can be a lot of noise in a quarter. But are you purposely being more selective in China or are you pursuing kind of opportunities that are maybe further below the radar screen that are inherently more profitable or maybe it's all just a coincidence in the quarter? That's the first question.

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

A

Yes, so in China, Jeff, our orders are up high single-digit. Our booked margin was up for the quarter in China. So, we returned to really to getting price in China on new equipment which was important to us. Our sales were up mid-single-digit. We also got price on service and grew our service portfolio 6% in China and grew our share year-to-date in China. So, we think we've got a solid performance. We did well in the tier 1 and tier 2 cities and especially in some of our strategic verticals like infrastructure where we've been spending a lot of time and investment. Rahul shared that we've added over 700, almost 750 agents and distributors in China this year, which has been an intense focus on us to have greater reach and greater capability to provide – to see the different opportunities and again, we return to positive booked margin there and we're pleased with that. We continue to invest in China with our new factory, and we're going to continue to make investments in the sales channel in China in Q4, as Rahul mentioned in his remarks, to get us prepared for what we think is going to be a growth segment and growth for us significantly in 2021.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners, LLC

Q

Great. And then maybe just back to the backlog commentary, certainly, I understand the relationship and what you're alluding to. Is an exit backlog growth rate a pretty good indicator of what we should expect for new equipment growth? Maybe you could give us just a little bit more color on kind of conversion cycles and, Rahul, you made the comment about trying to accelerate conversion of the backlog, just a little more color on how the whole algorithm works if you could.

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

A

Yeah, so Jeff, typically, what we see is we see in any given year, again, this is now I'm going back to a little bit to pre-COVID because what we typically used to see is about two-thirds of our revenue, new equipment revenue in a given year are coming from backlog. So, that's what we would have typically seen. This year, it has been a little bit lower just given all the disruptions that we've had both in the field and in the factories. And our goal as, I think, we've said it previously, our goal is not only to get back to 2019 levels, but drive a little bit higher than that. And so, we'll continue and provide more color and more guidance as we talk about 2021. But typically, what you see is two-thirds of the revenue for next year is coming from backlog, globally [indiscernible] (00:39:20).

Jeffrey Todd Sprague
Analyst, Vertical Research Partners, LLC

Q

Thank you.

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

Hey, John.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

I guess, maybe just the first one following on a couple of the pricing questions, and sorry to keep bringing up pricing, but when I look at your bridge on slide 10 and then I just go through each of the last quarters, the new equipment commentary that was called out, we haven't seen pricing in bad debt yet. So, was just curious if that's some conservatism because we're still in COVID, or once again, I think to an earlier question, that you know something's actually going to hit in Q4, so it's just a timing related issue.

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

No, we have had – the bad debt is higher, a little bit year-over-year. It hasn't been material enough to call out, but you would expect that in an environment like this, in the current environment, you would have incremental bad debt and we being appropriately cautious, I would say, on how we are reserving for stuff. So, if you're seeing things go in the wrong direction, we are providing adequate reserves for that. So, bad debt has been with us through the first nine months, and again, it hasn't been material enough to call on each line item but cumulatively kind of adds up, so it's okay.

Pricing, you're right. It hasn't been – we haven't called it out. As we said, our booked margins are flat. Kind of year-to-date, they're flat. Backlog margins are flat. But again, we are expecting a little bit of conservatism for Q4 just in case things happen. So, you're right. On pricing for new equipment, that is a comment more for Q4 and it does reflect a little bit of conservativeness on our part.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

Great. No, that's helpful clarification. And then maybe just a question on understanding the business a little bit better, but as we think about when service pricing takes effect, I think there is some concern that, depending on where vacancy rates are or building utilization rates, that we could see some pressure next year on service. But I think the way, as I understand it, there's kind of like rolling waves and would only be a portion that might even be impacted. But can you help us understand how that repricing might work on parts of the service portfolio that on any given year just as are kind of naturally rolling off contract?

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

Yeah, so our service contracts are contracts that are multiyear in many parts of the world and annual in others. So, each country is a little different. We tend to renew our service contracts in Europe early in the year and we do have price escalators there that are indexed to inflation and we'll be watching that as we enter next year as well. In the North America, where a lot of our service contracts are as well, we find that those are multiyear. The concessions we've given to-date have been pretty limited to the hospitality and the retail industry only. And as we've shared with our end market exposure, that's a little under 10% for us globally. And those concessions to-date have lasted typically for about 90 days and they all came in at staggered times.

But as long as a building is open – and it's important to note, John, that we also match our cost when those concessions go in terms of the services we deliver. So, we've been doing a good job in that, and that's why we've been able to maintain our service margins and our margin expansion. As these come up for renewal, every one of them, we discuss with the customers exactly what types of services they need to receive and then we adjust our costs accordingly. But we have not seen any unusual cancellations on either the new equipment side. Every now and then a job does cancel, but on the new equipment side or even on the service side, we've not seen extreme cancellations happening. Right now, everybody's kind of watching. And as long as a building is open or at minimum at use and all the residential buildings are at significant use, we are out there providing maintenance. Our maintenance pricing has held up very resilient and our maintenance has been very resilient. And really, it's the discretionary repair and modernization where we've had any of the decline in sales as people are making discretionary choices. I hope that was helpful.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC
Q

That was very helpful. Appreciate all that color. Thank you.

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

Nigel Coe
Analyst, Wolfe Research LLC
Q

Thanks. Good morning.

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

Good morning.

Nigel Coe
Analyst, Wolfe Research LLC
Q

Yeah, hi. So, I mean there's a lot of debt in the China public sector and there are some government concerns around that. Are you seeing any kind of cooling down measures that maybe might impinge on 2021? I mean are we seeing any, I don't know, RFP activity starting to dull down a little bit, any concerns on China as we go into 2021?

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

No, we have not seen – these cooling measures have been in effect now for almost three years, I would say. And we've not seen any impact on the infrastructure segment, which is mainly public. But even in the private, with the property developers, we have not seen any change in volumes or requests for proposals in China. And again, China, we expected as we started the year, the segment to be flat. The segment is actually growing this year and we actually now we believe that the segment will grow again next year. We're looking for a very positive outcome in China next year in 2021.

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

And just, Nigel, just to add a couple of just quick data points on that. I mean, if you look at the domestic loan volume for the real estate developers, that's actually up year-over-year. I think the estimates are like it's up 4% to 5%, and the land value that these developers has prepared is up 13%. So, they continue to invest in the business.

Nigel Coe
Analyst, Wolfe Research LLC
Q

That's great to hear. And then, on the discretionary repair, you mentioned there's some weakness there. What is the nature of this repair that's been deferred? Is it, I don't know, some cracks in the facade or are we talking here about [ph] caps (00:46:09) that are not working and they're moving down from 6 to 4? Does this create a significant sort of pent-up demand as we go into next year?

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

A

We do believe this is a demand delay, and it will create pent-up demand on the repair side. On the modernization side, we believe it'll occur. It's challenging to determine what quarter that's going to come back since so much of the modernization is discretionary. But the repair, we believe will happen. Some of it, we need access to those buildings. Some of it, the buildings need more usage and the facility managers are just holding on some of those discretionary repairs. We expect it to bounce back and we think we'll see a little more of it in Q4. And as we go into 2021, we expect that bounce back.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks, Judy. And then a quick one for Rahul, obviously, a lot of cash in the balance sheet. Once we get into a more sort of normal environment, whatever that means, how much cash do you think Otis needs to maintain going forward?

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

A

Yeah, it's a great question, Nigel, and that's something – again, we need a few quarters under our belt to exactly figure that out. I mean a lot of our cash is offshore. So, that puts – that makes a little bit harder to figure out exactly what that right number is. But safe to say, it's not $1.7 billion. I mean that that's easy to say that it's not. I think we have more cash than what we need which is appropriate in an environment like this because if you go back to March, April when you couldn't borrow in the CP market, so you want to be prepared because life is going to be uncertain at least for the next three to six months. But beyond that, we feel we don't need $1.7 billion and I think that's what our promise is to get back cash to the shareholders as and when things settle down a little bit. And we do feel that we should be in a position to accelerate our share buyback from 2022 into 2021. So, again, that's the stated objective. And we think we'll get there barring some really, really unforeseen events. So, we'll keep watching it. But it's not $1.7 billion and it's lower than that. What exactly that number is, I think we need a few more quarters under our belt to know exactly what the right number is.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. Thank you very much.

Operator: Thank you. And our next question comes from Denise Molina of Morningstar. Your line is now open.

Denise Molina
Analyst, Morningstar Holland BV

Q

Hi, thanks. Thanks for the questions. Denise Molina from Morningstar. Just want to go back to the comment you made about the 30% to 40% lift on service revenue from the connected services. Are those contracts that you think are adding like a couple hundred basis points of margin on top of what you would normally get on a contract? And then is that that level of revenue lift expected to carry across to wide like a customer base because if you've got a budget for these kind of yearly contracts, just wondering if you're expecting that to be widely adopted for everyone to kind of have another 30% to 40% in their budgets for these services or do you think they're sort of going to be for a certain high tier of your segment maybe high-population buildings?

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

A

Yeah, Denise, so my comment on kind of 30% to 40% was more around the fact. So, we have several connected solutions in addition to Otis ONE. So, we have a elevator management system. We provide the destination dispatch. We have eView systems that in parts of the world out there are connected. So, when you put all that together, that can add about 30% to 40% of the revenue that we get on that unit. And there's not a lot of incremental cost to support that. So, you would expect margins to be higher in addition to almost close to – as close to perfection retention rate as you can get. So, the retention rates are very, very high. So, there are lots of incremental benefit. And that was a comment in response to Carter's question on Otis ONE, do you expect incremental revenue from that? Yes, we do. It's not – again 30% to 40% is cumulative. So, it's not going to double from Otis ONE, but we do expect incremental revenue, because at the end of the day, the customer gets complete visibility on how the portfolio is performing. They get higher uptime because, as Judy responded earlier, we can dispatch a technician as soon as the unit breaks down. So, we know before the customer calls us, we know the unit is down so we can dispatch a technician. So, the uptimes are higher. So, we do expect over time, we will get revenue from this. But that has not been our primary focus. We are investing this. We're installing these units at our own cost because we think the productivity benefit outweighs the cost. So, that has been our primary focus, but over time, we do expect revenue.

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

A

Now, Denise, our conversion rates and our retention rates on connected elevators beats our industry leading retention rates across the globe. So, we have the ability to actually retain in our service portfolio those connected units at several hundred basis points above what we do with our normal retention rate globally. So, that's another added benefit for us. It gives us more years on service and the ability to be with that customer over time, especially when they want additional upgrades over time.

Denise Molina
Analyst, Morningstar Holland BV

Q

Can I just ask one follow-up on that because we've heard a lot from Kone and Schindler as well on their connected services and I think we're trying to figure out what the differences are amongst the players. But it sounds like the ISPs are the ones that are maybe not going to be able to compete as much because they don't have any many elevators, kind of feeding the information to get those good kind of uptimes. Do you think that's right? Do you think that if you're going up against – and it's difficult to say but if you're going up against another OEM that had the same number of elevators feeding those algorithms, do you think your services would be differentiated still?

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

A

Listen, 55% of the service market right now is controlled by ISPs. That's who we're going to get share from to grow our service portfolio above our leading service portfolio of over 2 million units already. And we do believe that with scale and with differentiation comes incredible data and clarity in terms of being able to make decisions, having a data lake, being able to do predictive and transparent maintenance, and as Rahul said, to get the – to roll the trucks and to get our field professionals out there as quick as possible to drive uptime. It's the value of that data and the analytics that's going to make a difference, and we are – that's where we're going after share. The ISPs have more than half of the share globally, and that's what we intend, especially to get our Otis units back.

Denise Molina
Analyst, Morningstar Holland BV

Q

That's very helpful. Thank you.

Operator: Thank you. And our next question comes from Cai Von Rumohr of Cowen. Your line is now open.

Cai von Rumohr
Analyst, Cowen & Co. LLC

Q

Yes. Thanks so much. So, backlog margin, you indicated that it's flat. Schindler, on their call, talked of pricing getting worse in the third quarter, and therefore, looking for backlog margin to be down in the fourth quarter. What are you looking for? Can you hold that backlog margin in the fourth quarter?

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

A

Hey, Cai, listen, [indiscernible] (00:53:24) to comment on future of backlog margin. The good news is, listen, you look at the booked margin, that's up. You look at the backlog margin that's flat to last year and it's in and out. But generally, if you – what my takeaway from this is that the pricing environment in both new equipment and service is largely stable. There will be – will there be pressures as we've discussed previously? Yes. But I think the new equipment markets are behaving right. China booking margins are up. North America was up, little bit of pressure in Asia Pacific especially in India and Southeast Asia as you would expect, a couple of markets in EMEA as well. So, all that, we put all that in and it's good to see the booking margin being up and the backlog margin being stable.

I think Judith made the comment on service pricing as well and that's okay as well. I mean outside of the temporary price concessions and these are temporary because they are for a limited period of time, outside of these temporary price concessions, the overall service market is holding. Europe was – I mean Europe was up. North America was up, overall pressure in Asia as you would expect, but service pricing looks okay as well. So, we feel good about where the environment is. Would there be pressure? Absolutely. If there is, we are ready for it, right. I mean we are kind of ready for the pressure that may come, but it has not manifested yet and we feel okay where we are.

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

A

Yeah, and we have shown now for multiple straight quarters that we are yielding on the productivity both on the material productivity side for new equipment and the service productivity side is continuing to yield. And I do pivot back to our service business which has remained resilient despite the discretionary challenges we've been facing and that's 80% of our margins. We shared our medium-term outlook and basically said our future is based on growing our service portfolio, driving margins in both new equipment and service but in service, that plus other action's driving high single-digit EPS. We are on track for our medium-term outlook, our strategy is on track, and that's what we're executing.

Cai von Rumohr
Analyst, Cowen & Co. LLC

Q

Terrific. And then your third quarter orders were bolstered by three very large wins that you had. Are you looking for large wins in the fourth quarter or are we looking at a tougher orders compare?

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

A

There were probably wins last quarter as well, Cai. I think I'm sure we had a few sizable wins in Q3 of last year, so I don't know year-over-year these large wins necessarily made a difference. And I think we've been talking about the things, Cai, that are driving our sales performance. I mean, if you look at our coverage in certain markets whether it's China, whether it's the rest of Asia Pacific, whether it's markets in Europe, I mean our sales coverage in those markets that we have targeted are up anywhere between 7 to 10 points. So, we are doing really well and just doing the basics right. I mean Judy and I both said, we've added more than 700 channel partners in China. We've added more than 100 salespeople. So, we're are putting more feet on the ground. We're attacking new segments. We didn't have a product in the entry tier market. We do now. We launched them in India. We're expanding to Southeast Asia. We're attacking the volume business in certain markets where we didn't play. So, it's a pretty all-out front on making sure that we continue to gain share. And these large wins are a testament to the technology and the customer relationships. But it's broader than that.

Cai von Rumohr
Analyst, Cowen & Co. LLC

Q

Terrific. And then last one, so listening to your competitors, the three markets, they've all been complaining about are the Americas, Asia outside of China, and Southern Europe, all markets where you have substantially greater percentage of revenues than they do. Can you maybe comment on, is that just share gains on your part? And you mentioned 70 bps of share gains, where do you think you're gaining share and where are you may be losing share?

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

A

So, yeah, we have – if you take our Asia world outside of China, we are very pleased this year with our results out of Korea and Japan, where we are a major player, and that has happened in both new equipment and in service, especially in service in Japan. So, our Asia Pacific, although impacted by India and Southeast Asia like the rest of the world, we're really pleased with our share gain there and we have put some of those sales investments in place there to deal with both the new regulations in Korea, but also just to get more share on the new equipment side. As we pivot to the Americas, I was really pleased with our performance in Latin America. We grew share in Brazil and we are continuing to perform well in Latin America. North America remains very competitive and we're going to continue to watch that closely. And we've looked – we gain the same access to the [ph] Dodge and the ABI (00:58:27) information and [ph] Dodge (00:58:29) has marginal improvement but up for next year, and we just have to watch the pace of that deal with what we can control, work our backlog conversion quicker, and then drive productivity throughout, especially in North America and align our costs with that.

In South Europe, that is the heart of our maintenance portfolio and our teams have done a great job aligning cost with the service we're providing and really having minimal concessions. So, on the new equipment side, we think we're seeing new starts in Europe including in South Europe and we're seeing it really across the board, new starts in EMEA, a little slower in the Middle East. But the Asian economies are turning the corner led by China by far. But the rest of the Asian economies are starting to turn. The only place we still have constraints in terms of job site access is really in India, which is less than 50% and parts of Southeast Asia. Everywhere else has been restored to the high 90% and we haven't seen any retreat from that due to this second rebound of COVID either in North America or EMEA.

Cai von Rumohr
Analyst, Cowen & Co. LLC

Q

Terrific. Thank you very much.

Operator: Thank you. And ladies and gentlemen, this does conclude our question-and-answer session. I would now like to turn the call back over to Judy Marks for any closing remarks.

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

Well, let me thank you all again for joining the call this morning. I need and want so much to thank our colleagues for their dedication, as well as all of those on the frontline fighting COVID-19. Please stay safe and well. Thank you.

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

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