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Otis Worldwide Corp. (OTIS)

Q4 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to Otis' Fourth Quarter 2022 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 the call over to Michael Rednor, Senior Director of Investor Relations. Please go ahead, sir.

Michael Rednor

Senior Director-Investor Relations, Otis Worldwide Corp.

Thank you, Norma. Welcome to Otis' fourth quarter 2022 earnings conference call. On the call with me today are Judy Marks, Chair, CEO and President; and Anurag Maheshwari, Executive Vice President and CFO. Please note, except where otherwise noted, the company will speak to results from continuing operations, excluding restructuring and significant non-recurring items. A reconciliation of these measures can be found in the appendix of the webcast.

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

Judith F. Marks

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

Thank you, Mike, and thank you, everyone, for joining us. We hope everyone listening is safe and well. We're pleased that we ended the year with a strong fourth quarter and solid full year performance in a year characterized by a variety of macro headwinds.

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We enter 2023 with good momentum as we continue to execute our four strategic pillars: sustaining New Equipment growth, accelerating Service portfolio growth, advancing digitalization, while focusing and empowering our organization. I am proud of our colleagues around the globe who delivered these results, demonstrating the strategic resiliency of our company as we continued to grow and perform in 2022.

Starting on slide 3. We continued to perform well in New Equipment orders, growing 7% for the full year. In the quarter, orders grew 4% with particularly strong performance in EMEA and continued solid performance in Asia Pacific.

China orders returned to growth, with mid-single-digit performance in the quarter. Orders in the Americas were down 4% in the quarter, although the business had a very strong 2022 overall, with orders up almost 18%. Our New Equipment adjusted backlog at constant currency is up 11% heading into 2023, giving us solid multi-year visibility to grow sales.

Organic sales increased 2.5% driven by Service which grew 6%. We grew our industry-leading maintenance portfolio by 4.1% it now stands at 2.2 million units, a new milestone for our company.

We delivered 7.5% adjusted EPS growth despite $156 million in foreign exchange-related headwinds. We generated $1.45 billion in free cash flow, allowing us to return $1.3 billion of cash to shareholders through dividends and share repurchases. We continue to win many exciting projects based on our innovation, ability to deliver, and the trust customers have in us.

For example, in the Americas, Otis was selected to provide our Compass destination dispatch system, along with six SkyRise and two Gen3 elevators for City Centre 4 in Surrey, British Columbia. The 23-story building will be built to LEED Gold standards and extends our more than six-year relationship with the Lark Group.

In China, Tianjin Metro has been using Otis Equipment since opening in 1984. In November, Otis was selected to provide more than 120 escalators and Gen3 elevators for their new Line 4 northern extension. This takes the number of Otis units on the port city's expanding subway network to more than 1,500. These new elevators will be connected to the Otis ONE IoT-based platform already delivering real-time monitoring and predictive maintenance for the metro system.

In the UK, we've had a long-standing relationship with Transport for London, including a long-term contract through 2042 to manufacture, install, and maintain the escalators and travelators on the busy network. Most recently, we were contacted to provide Battersea Station with specialty escalators specifically designed to run for about 20 hours a day and extend 24 meters in length, 9 meters in rise. We're playing our part to keep the busy network flowing.

Our ESG initiatives continued to progress in 2022, helping to drive stakeholder value alongside our financial priorities. Our manufacturing facility in Florence, South Carolina achieved Gold-level Total Resource and Use Efficiency or TRUE certification, recognizing its success in zero waste. With this achievement, Otis has become the first in the elevator industry to have a TRUE-certified facility, helping us towards our goal of having all our factories eligible for zero-waste-to-landfill certification by 2025.

We look forward to sharing more about our ESG progress in our second annual ESG Report, which is said to be published in the spring.

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Moving to slide 4. With strong orders performance in 2022, we were able to achieve approximately 1 point of New Equipment share gain on top of the 2-point increase between 2020 and 2021. For the first quarter since Q4 2021, New Equipment sales returned to growth as we continued the strong growth in EMEA and Asia Pacific that we've experienced all year and were able to overcome supply chain and installation-related challenges, specially in the Americas.

These results mitigated the impact of mid-single-digit New Equipment sales decline in China, demonstrating the power of geographic diversification within our business. Notably, we see China on a recovery path as New Equipment sales in the region improved compared to Q3.

Innovation is helping to drive growth across our business. For example, we continued to rollout our digitally connected elevator platforms, launching Gen3 in India, and expanding the deployment of Gen360 in Europe to the Czech Republic, Poland, Portugal, and Slovakia. The accelerated portfolio growth we saw this year is an essential component of our long-term strategy and top line growth algorithm.

We believe the disruption in our industry favors the OEM, and we're demonstrating this as we deploy our Otis ONE IoT solution into our New Equipment product offerings and our Service portfolio. We continue to work towards our goal of increasing connectivity to approximately 60% of the portfolio, and we're pleased to have connected more than 1,000 additional units this year.

Our Service sales force performed well throughout the year, with like-for-like maintenance pricing of 3 points, helping to mitigate labor cost headwinds within the Service business. For the third year in a row as an independent company, we delivered adjusted operating profit margin expansion and we remain well-positioned as we enter 2023 with momentum, specially as we execute on New Equipment projects from our backlog.

Now, turning to slide 5. In the Americas market in 2022, while North America had a strong year, up better than mid-single digits; Latin America was roughly flat, leading to a market that was up low- to mid-single digits.

In EMEA, Western Europe performed well, offset by Eastern Europe due to the conflict. In Asia, the market was down high-single digits. Asia Pacific had a very strong year, up approximately 10%, with the performance matched by the downturn in China which we estimate to be down about 15%.

Although market dynamics remain fluid, as we've seen over the past several years, the long-term fundamentals of the industry are well grounded in the Service-driven growth model. In 2023, globally New Equipment markets are expected to be down mid-single digits in units with flattish markets in the Americas and EMEA and down mid-single digits in Asia, driven by China where we expect the market to be down 5% to 10%.

Asia Pacific should see another year of mid-single-digit or better growth driven by urbanization in the region and infrastructure investment. The global industry installed base is expected to grow at a similar rate to that of 2022 at about mid-single digits and reach approximately 21 million units.

In the Americas and EMEA, we expect low-single-digit growth. And in Asia, we're expecting high-single-digit growth driven by China. With this as the industry backdrop for Otis, we expect organic sales growth to be in the range of 4% to 6%, with total sales of $13.8 billion to $14.1 billion, up 1.5% to 4% at actual FX.

By segment, we expect New Equipment will grow 3% to 5% this year, with mid-single-digit growth in the Americas and EMEA and low-single-digit growth in Asia. We expect Asia Pacific to grow at least mid-single digits while we anticipate our China New Equipment business to be about flat for the year. We're expecting a better China market

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as we get into the second half of 2023, as COVID-related and liquidity constraints in the market should ease on the back of government support.

In the Service segment we anticipate another year of solid growth, with the business growing 5% to 7%. We expect volume and pricing to drive solid mid-single-digit growth in the maintenance and repair business with higher growth in our modernization business line. Our modernization orders performed quite well over the past few quarters and we entered the year with a mod backlog up 7% at constant currency. We expect 7% sales growth at the midpoint, driven by the backlog growth.

Adjusted operating profit is expected to be between $2.2 billion to $2.25 billion, up $70 million to $130 million at actual currency or $130 million to $175 million accounting for foreign exchange headwinds. We expect adjusted EPS to be in a range of $3.35 to $3.50, up 6% to 10% or approximately $0.26 at the midpoint versus the prior year. Finally, we expect free cash flow of $1.5 billion to $1.55 billion, between 105% to 115% of GAAP net income.

We remain committed to our disciplined and balanced capital allocation strategy and expect to repurchase $600 million to $800 million in shares this year, following the new board-authorized $2 billion repurchase program, in addition to paying dividends and pursuing our typical bolt-on M&A strategy.

With that, I'll turn it over to Anurag to walk through our 2022 results and 2023 outlook in more detail.

Anurag Maheshwari

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

Thank you, Judy, and good morning, everyone. Starting with fourth quarter results on slide 6. For the fourth quarter, reported sales of $3.4 billion were down 3.6%. Organic sales grew for the ninth consecutive quarter and growth accelerated to 6%, our best performance of the year, with mid-single-digit growth in New Equipment and high-single-digit growth in Service.

Adjusted operating profit, excluding a $49 million forex headwind, increased $39 million with constant currency growth in both segments. Strong Service performance, especially in volume and price, was partially offset by commodities and mix headwinds in New Equipment, as well as higher corporate cost.

Adjusted SG&A expense for the quarter and the year improved 80 basis points as a percentage of sales, as we remain vigilant on structural cost reduction and cost containment to help mitigate the macro headwinds we have faced. At the same time, we're committed to growing the business and R&D and strategic investments as a percent of sales remained about flat.

Adjusted EPS grew 4% or $0.03 in the quarter, driven by operational growth of $0.07. This strong operational growth, alongside the accretion from Zardoya and $850 million of share repurchases, more than offset the $0.8 headwind from forex.

While the fourth quarter free cash flow conversion was strong at 145%, our full year free cash flow came in at $1.45 billion or 115% of net income, lighter than we had anticipated as we built $65 million of inventory to mitigate supply chain challenges and support backlog conversion going into 2023.

Moving to New Equipment performance on slide 7. Otis New Equipment orders in the quarter increased 4% with EMEA and Asia Pacific up high-single digits and China orders returning to growth up mid-single digits which more than offset a modest decline in the Americas. Overall, with better-than-expected orders growth in the quarter, we

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finished the year with a New Equipment adjusted backlog up 11% at constant currency with growth in all regions, including, notably, in China.

Pricing on New Equipment orders in the quarter increased 3 points led by the Americas, with solid performance in EMEA and APAC. In China, we have been roughly price/cost neutral throughout 2022 as commodity inflation [indiscernible] (00:14:43) and we continue to drive productivity to offset pricing pressure in the market.

Fourth quarter New Equipment sales are $1.5 billion return to growth, driven by over 10% growth in Americas, EMEA, and Asia Pacific with EMEA outperforming our prior expectations. China sales declined at a lower rate than what we saw in the middle of the year as the team navigated well through post-lockdown COVID outbreaks to execute on the backlog.

Overall, strong execution by the team [ph] driven by (00:15:18) return to sales growth in the fourth quarter in New Equipment. Operating profit margins were roughly flat for the quarter, the benefit of higher volume, strong productivity, and cost containment really mitigated the approximately of $25 million in headwinds from commodities and forex.

Now, turning to Service segment performance on slide 8. We saw an acceleration in our portfolio growth to over 4% with every region adding to their portfolio this year. With another year of excellent high-teens growth in China and low-single-digit growth elsewhere, our portfolio now is about 2.2 million units. Globally, our recaptures more than offset our cancellations for the year, with conversions as the growth driver. Additional details on our portfolio growth in 2022 and drivers for future growth can be found in the appendix.

Modernization orders were also highlight, up 13%, with growth in all regions, including some major project bookings in the Americas and Asia Pacific and continued strength from our mod package offerings. Our modernization backlog is up 7% versus the prior year, giving us good line of sight for growth in 2023.

Moving on to Service sales, we delivered another quarter of strong organic sales growth, up almost 7% with growth at all lines of business. Maintenance pricing, excluding the impact of mix and churn, came in as expected, up about 3 points for the year, contributing approximately 1 point to overall revenue growth. Organic modernization sales grew 8.8% and, similar to last quarter, we saw broad growth across regions including double-digit growth in both Americas and Asia Pacific.

We finished with our best Service margin expansion for the year, up 70 basis points in the quarter. Adjusted operating profit, excluding $42 million of forex headwind, was up $51 million as higher volume, favorable pricing, and productivity were partially offset by annual wage increases. We have now delivered 12 consecutive quarters of Service margin expansion with margins increasing roughly 200 basis points over the past three years.

Slide 9 lays out the full year 2022 adjusted EPS bridge. Strong operational execution drove $0.39 of constant currency EPS growth, which mitigated $0.18 in commodity headwinds, leading to operating profit growth of $124 million or $0.21.

Through our capital allocation strategy, including the accretion from the Zardoya transaction and share repurchase of $850 million and optimizing our tax rate, we were able to offset $0.26 in forex headwinds. Overall, strong operational performance led to EPS growth of 7.5% or $0.22.

We finished the year with 2022 adjusted tax rate of 26.5%, a 220-basis-point improvement versus 2021, which contributed to EPS growth both in the quarter and for the full year. Overall, the team performed well throughout

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2022 by executing on the controllables which helped us to build a strong backlog, grow organic sales, expand margin by 30 basis points, and return $1.3 billion to shareholders.

As we look ahead to 2023, the New Equipment outlook is on slide 10. Over the past few years, we have delivered strong orders globally from a combination of market growth, our share gain initiatives, and incremental pricing actions. This has resulted in a robust multi-year backlog giving us good line of sight for the next couple of years.

In 2023, we expect New Equipment organic sales to grow between 3% to 5%, with Americas and EMEA up mid-single digits and Asia growing low-single digits. Asia Pacific is expected to be up at least mid-single digits and, though the backlog in China is up 2 points, we expect sales to be about flat, reflecting pressure on the book-and-ship business from expected market declines in the first half.

We expect New Equipment profit margins to be flat to up 40 basis points. We expect roughly $100 million of tailwinds from volume, pricing, productivity, and commodities. This will be partially offset by unfavorable regional and project mix and some snapback in SG&A expense due to 2022 cost containment actions. We will continue to drive strong productivity on both material and installation and project closeouts as the year progresses to drive outperformance.

Turning to our Service outlook on slide 11. Starting with sales, we expect another solid year in Service, and anticipate organic sales increasing 5% to 7%. Maintenance and repair organic sales are expected to grow 4.5% to 6.5% driven by maintenance portfolio growth, pricing, and low- to mid-single-digit repair growth after two strong years of COVID-related recovery. We expect more than 1 point of pricing after adjusting for mix and churn.

For modernization, we anticipate organic sales of mid- to high-single digits as we execute on a solid backlog and drive our book-and-ship business from new product launches and focus on sales force specialization.

Turning to profit, we expect roughly 50 basis points of margin expansion. Headwinds from annual wage inflation will be more than offset by volume, price, and productivity – similar drivers to 2022.

Turning to slide 12 for the 2023 adjusted EPS bridge. We are expecting $3.35 to $3.50 in adjusted EPS, driven by $0.23 to $0.31 of operating profit growth. We expect to offset $0.9 of forex headwind at the midpoint and a modest increase in interest expense through a lower share count, $0.4 of remaining Zardoya accretion, and continued optimization of the tax rate. We plan to complete $600 million to $800 million in share repurchases during the year.

For cadence, we expect strong EPS growth in the second half of the year, while the first half remains roughly flat. We see the bulk of the FX headwind, post-lockdown COVID impact in China, and a modest supply chain overhang in New Equipment in the first quarter. We anticipate stronger growth sequentially thereafter, including better performance in China in the second half of the year.

Overall, we anticipate Otis organic sales growth of 4% to 6% with approximately 20 basis points to 30 basis points of margin expansion, leading to 6% to 10% EPS growth. And on cash, we expect to generate $1.5 billion to $1.55 billion in free cash flow in 2023, 110% conversion of GAAP net income at the midpoint. This outlook demonstrates another year of consistent and solid operational execution as we continue to mitigate macro challenges and create meaningful shareholder value.

With that, I will request Norma to please open the line for questions.

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] One moment for our first question. Our first question comes from Julian Mitchell from Barclays. Your line is now open.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning and thanks very much. First off, I suppose, I just wanted to dig in a little bit more into the assumptions for how you see the China market starting out the year in terms of orders after a very good Q4 performance. And maybe just [ph] home in (00:24:00) a little bit more on the commentary around some of those headwinds in Q1, should we still expect EPS to be up kind of sequentially in the first quarter?

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

A

Well, good morning, Julian. It's Judy. Let me start with what we were seeing really on the ground. I would tell you, the Chinese economy is in a state of recovery now. We were really pleased with our team's performance in the fourth quarter, again, with orders being up in New Equipment in what was a challenging quarter with all the lockdowns.

It's a fluid situation on the ground between liquidity and the COVID-related absenteeism as we come back from the Chinese New Year. And we're going to watch that closely, but 2022 came in where we expected on the market, down about 15%. We shared, we think, that was about down 10% in Q4 and came in where we thought, between 540,000 and 550,000 units.

Obviously, Q4 saw some abrupt changes with COVID between the lockdowns and then the lifting, which led to the outbreaks. And what we're monitoring is the liquidity easing, which were seeing, and where the consumer sentiment and confidence is in terms of the property market.

So, as we go through the first few quarters of 2023, first of all, we're very encouraged by the government policy and actions to-date. We are expecting a better second half. We have a harder compare in the first half based on what was happening in China first half of 2022, but we did see an up infrastructure market; that was the only segment that was up in 2022 in a 15% down market, and we did very well there.

Perry and the team just executed really well. Tier 1 and 2 in China were the least negatively impacted by the down market. And again, you know our strategy there has been very focused on agents and distributors on key accounts, and we've executed that.

So, I'll leave it with I'm feeling good about the health of our business in China. In a down market in 2022, we did well. We were down mid-single digits versus a down 15% market. And in a down 5% to 10% market, we expect to do well as well. So, we gained share last year. Our strategy will enable us to do that and we're going in with backlog.

I'll let Anurag talk to the EPS question.

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

A

Great. Thanks, Judy. Yeah, so Julian, just on the quarter one, let me start with the segments first. From a Service perspective, we expect to see performance in line with the full year guidance. The swing factor could be repair or modernization or some mix. But overall, we aren't seeing anything major to call out; and expect kind of mid-single-digit growth and margin expansion. It may be not close to the 50 basis points we're guiding for the year, but still be good expansion as we run through the year.

The New Equipment is a segment that we do expect some weakness, from both a sales and a margin perspective. Specifically compared to last year, China has a tough compare as the COVID impact didn't really start until the second quarter. And while we – as Judy mentioned, we do expect better performance in China as we go through the course of the year, we aren't expecting it to happen until the second half of the year.

In Americas, the team performed very well in the fourth quarter, but there's still some supply chain inefficiencies and labor shortages, which I expected to clear up in the second or third quarter. So, overall, we expect sales on the New Equipment side to be down quarter-over-quarter and year-over-year; and margins to be above flattish with where we ended up in the fourth quarter.

Now, kind of going to the other line items, starting with corporate expenses. Last year, the first half was light because of all the cost containment we did. So, it is going to – the runway is going to pick up very similar to what we saw in the fourth quarter. So, there could be a couple of pennies of headwinds over there.

And then, in – on the FX side, we've said about at the midpoint $55 million of FX headwind, and a bulk of it will come in the first quarter. Because last year at this point in time, the euro was €1.15, the renminbi was RMB 6.35. So, though the currencies have improved, there is still a significant headwind. So, majority of our FX headwind will come in the first quarter.

So, putting it all altogether, we do expect EPS to be down a couple of pennies as forex, any – our New Equipment, corporate will kind of offset the good performance in Service and the Zardoya accretion. So, net-net, down a couple of pennies; and sequentially, also could be down $0.01 or $0.02.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

That's extremely helpful. Thanks very much.

Operator: Thank you. One moment for our next question. Our next question comes from Steve Tusa with JPMorgan. Your line is now open. Steve, your line is now open. Mr. Tusa, are you on mute?

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

A

Norma, let's go to the next question. Thank you.

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

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Nick Housden
Analyst, RBC Capital Markets

Yes. Hi, everyone. Thanks for taking my question. I'll just ask one. In looking at the outlook, and maintenance in particular, you're guiding for up 4.5% to 6.5% organic. I'm just thinking, units are increasing over 4% and you seem pretty confident in being able to maintain that kind of level. Pricing is already at 3% and it's probably going up as you enforce the escalation clauses, and you kind of hint at that in the slide. So, 4% volumes, 3% pricing. Am I wrong to think that a 5.5% midpoint in the guidance looks a little bit conservative, and is it to do with maybe pricing being bit more competitive in Asia Pacific where a lot of the new units are going into [ph] next (00:30:19)?

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

Let me – Nick, good afternoon. Let me answer the pricing question and then I'll let Anurag take you through the walk. Listen, we're – we've been pleased like-for-like pricing similar to Q3 was up 3 points in Q4 and was very solid, as predicted. Mature markets globally is where we saw really strong Service pricing; mid-single-digit gains in the Americas, low-single-digit in EMEA and Asia Pacific. And as Anurag said in his comments, kind of we've got this – the margin drivers are really less on price and more on productivity, volume, and density in China.

But we think 2023 like-for-like should be better than that 3%, and that's really driven by the inflationary clauses we have in the majority of our contracts – Service contracts, especially in Western Europe and in North America. The Western Europe clauses are backward-looking, so they will reflect 2022 inflation indices. And we are signing those contracts right now, a lot of them in the first quarter. So, next quarter, we'll be able to be able to share how we're performing on that, but pricing's healthy. Team deserves a lot of credit. We pivoted from being a discount kind of Service pricing company for many years, to being able to gain price especially where it was appropriate and justified.

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

Yeah. And just to add to that in terms of the growth for 2023. So, yeah, you're right that our growth at the midpoint is very similar to where it is in 2022, but the pieces are little bit different. The portfolio growth, as you put together, 4%, and when Judy spoke about the pricing, you add 3% then you adjust for churn and mix, we should be up about 6% for 2023, which is higher than where we were in 2022.

Repair, as I mentioned in my prepared comments, over the past two or three years, we've been running at a 10% CAGR on the repair business coming out of COVID. Now, typically, the repair business will outgrow the maintenance business because as we continue on our strategy on new repair packages, increasing penetration. But this year, there'll be a – this will be a little bit of a catch up from what happened in the past two to three years. And then, going forward, it should outpace the maintenance business. So, that's why [ph] we're saying (00:32:49) low- to mid-single-digit.

And modernization is pretty – around 7-ish percent at the midpoint. So, those are the pieces which get us to 5.5%. Now, clearly, if pricing is a little bit better, repair comes in better, and we – the modernization book-and-ship, there could be a little bit more over there. But right now, we feel well calibrated at the midpoint of the guidance.

Nick Housden
Analyst, RBC Capital Markets

Okay. Great. That's very helpful. Thank you.

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Operator: Thank you. One moment for our next question. And our next question comes from Gautam Khanna with Cowen. Your line is now open.

Q

Hi, guys. This is actually [ph] Jack (00:33:32) on for Gautam today. Thanks for the question.

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

A

Hi, [ph] Jack (00:33:36).

Q

Hi, there. Just a quick question kind of just on your perspective on the end market demands. Kind of back to Judy's comments on the first question, just kind of what you're seeing in the field today maybe by geography and then by the end market, maybe kind of parsing resi versus commercial or infrastructure? Just anything there would be helpful.

And then, just if you're seeing any – with the slowing global macro backdrop here, if you're kind of seeing any municipalities or other customers sort of defer projects or kind of what you're seeing in 2023 so far?

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

A

Sure, [ph] Jack (00:34:22). Let me try and respond to both parts. Let me start with New Equipment, because I'll break this into New Equipment and Service, and I'll actually start with Asia Pacific where the market overall – and we're really expecting solid growth due to urbanization and infrastructure growth in Korea, in Southeast Asia, and in India. And we're not seeing any slowing in that part of the world, it's really accelerating; and expectations should be for solid growth.

For 2023 in the Americas, we think it's going to be a little worse than the market was in 2022. 2022 was an incredibly strong market, first half stronger than second half. But as we saw, a really strong market. And we're still seeing the Dodge Momentum Index rising on construction, but the Architects Billing Index (sic) [Architecture Billings Index] (00:35:12) for the past three months has been under 50, including December at 47.5. So, we're watching that carefully.

In EMEA, we think flattish. We're balancing potential headwinds. But I'll tell you, we have seen Europe become far more resilient in terms of the demand, including the residential market in Europe is really strong despite all the challenges consumers are facing; and the Middle East is growing. Middle East, although it's a smaller part of our EMEA, has bounced back nicely. So, that end market's going to grow as well.

The good news in China, it's going to be better year-on-year than last year. Second half looks better. Again, segment down, we're predicting 5% to 10% in 2023, down a little more on the first half. And then, we expect to see acceleration through the second half. So, we look at that, as we shared in the 2023 outlook slide, and we're prepared for that because we've got this great backlog at 11% on New Equipment.

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When I turn to the Service business, it's – the end market's just growing in all regions. It's solid mid-single-digit growth led by Asia and low-single-digit really in the developed markets. And I'd just make you recall that the New Equipment market swings really have minimal impact on the Service market. It's going to grow mid-single-digit year after year after year. Modernization is up nicely in all regions and we're ready for that, we're going in with a 7% backlog on mod and we expect mod to continue to – from a demand side, to continue to grow in 2023.

We have not seen a slowing on projects. We've also not seen the impact of the Inflationary Reduction Act (sic) [Inflation Reduction Act] (00:37:06) – the infrastructure – the reduction act in North America yet, where we see that later cycle in terms of airports, metros, and other infrastructure. But again, we did see good infrastructure. It was the only positive sector and segment that grew in China in 2022.

So, we're feeling good, our backlog will take us through. Again, we'll watch the book and bill early in the year but our backlog, we think, is going to take us through on New Equipment and mod and our Service business is coming in strong, and we're looking forward to 2023.

Q

Thanks, Judy. Yeah, that's really helpful. And then, just one quick one for Anurag, really quickly just on price/cost assumptions in 2023 and sort of the backlog margin converting here, just kind of what your assumptions are [ph] staffing the line (00:38:04) on seeing raw materials sort of roll over here in 2023 kind of just high-level, how you're kind of thing about price/cost in 2023? Thanks.

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

A

Okay, great, and thanks for the question. So, price/cost is positive in 2023. I mean, you can see it from the margin expansion as well that's happening at the midpoint. So, on pricing, if you look at this year, I mean after flattish first half, we started seeing pricing going up 3% in the back half and our backlog is actually up – our backlog margins are up over 100 basis points.

And we have assumed for next year is about 50 basis point of pricing coming through into the P&L, which is roughly about $30-ish million. And the reason that 50 basis points are not what we have right now is it takes a while for the backlog to convert into revenue, and some of that will come in the later years, but still are price positive.

On commodities, we do expect about a $20 million to $30 million tailwind. If we look back over the past two years, we've faced about $180 million of commodity headwind, slightly more than $100 million came from Americas and China, and the rest came from Europe and Asia.

In Americas and China, of the $100-million-odd headwind, we're seeing about $30 million, $40 million of that come back because prices of steel have started coming down. And though we have 50% locked, we still see some of it coming down [ph] over years (00:39:29), so clearly that is very positive.

It is actually in EMEA and in Asia Pacific where we're not seeing the tailwinds right now. In Europe, if you look at guide rails, it's still up 85% from where it was two years ago. So, clearly, there is some headwind over there. And in Asia, we buy a lot Tier 2 suppliers, and that's not yet come down as well. But, overall, we see about a $20-million, $30-million tailwind on commodities. So, net-net, between price and commodities, it's positive.

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Thank you.

Operator: Thank you. One moment for our next question. And our next question comes from Nigel Coe with Wolfe Research. Your line is now open.

Nigel Coe
Analyst, Wolfe Research LLC

Thanks. Good morning, everyone. Thanks for the question. Just wanted to run through some of the puts and takes on margins. And I think you're calling out mix impacts in New Equipment. So, just maybe just double click on that and just clarify what sort of the mix headwinds are.

But my real question is [ph] really on (00:40:33) investments. I mean, you continue to invest – I think that's been very successful on the recaptures and the retention initiatives. So, maybe just talk about the focus for investment spend going forward.

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

Yeah, let me start with the investment spend, and then I'll have Anurag talk to the mix. Yeah, we are – I think you've seen, Nigel, since we became independent, we've been obviously focused on our business, focused on our markets, and we've been extremely focused on investments in our strategy that we yield in terms of innovation.

So, we've done – we've continued our investments in our Service business, both in making our incredible field professionals more productive, and that's yielded; our – the apps that they've been using continue to show incredible promise. Our Tune App is up in terms of usage, 70%. In terms of in the field, we've got lots – a lot of our Service parts being ordered. And our sales – our field professionals using the Upgrade App are also being part of our extended sales force and selling repairs.

So, all that's working well, but the linchpin of our strategy is Otis ONE. It's being connected. It's having that predictive, transparent information available in our ecosystem. And we continued on or investment strategy for Otis ONE, again, where we define on the Service side where we're going to install these to get the best yield for both productivity and customer stickiness.

So, what we're seeing – we did deploy well over 100,000 units again this year on our trajectory to a 60% coverage of what's becoming a larger portfolio; 2.2 million this year, we said we'll be over 2.5 million units by 2026 in our medium-term. And that 60% should be off that two point – that higher number. That's where we're heading.

And we're seeing the results of that. We're seeing it on the productivity side, where our running on arrivals are down; and we're seeing that also on the customer stickiness side in two ways. One is, when we are connected, like our eView product or any connected product, we're getting more in price for Service, and then we're getting higher conversion rates and higher retention rates.

Our retention rates this year, we were pleased with; they're at 94%. I look forward to the day that we can report a 95% retention rate because that will have significant validity to our Service-driven growth strategy. Conversions

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were up this year and I think a lot of that, especially in China, going up to 48% this year, where they ended was due to our Gen3 elevators being connected and our Otis ONE units as well.

So, globally, we're now at a 64% conversion rate. And as China continues on its path to get to 60%, which we think is the target, then globally we will be at about 70% conversion and that is our higher-margin conversion.

On the portfolio itself, that – it is Otis ONE, it is that connected product that gives us the conviction that we can take the 4.1% portfolio growth even higher. Even though this is what we shared for the medium-term guide at about 4%, we do believe we can get that higher, including in 2023.

So, all in all, investments in the New Equipment side are continuing. Our R&D spend is there, our strategic investments are there. We're really pleased with expanding Gen3 and Gen360. On the Service side, the Otis ONE value proposition for the customers is working, and we believe it's reflected in our margin expansion as well for our shareholders.

So, Anurag, let me turn it over to you for mix.

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

A

Yes, thanks. So, as you can see, on the investment side, we'll continue to invest and still grow our margins. Last year, we grew about 30 basis points. This year, we're guiding for 20 basis points, 30 basis points. And we'll look for productivity other ways to kind of offset that.

On the mix, it's two, it's regional and product – project mix. On the regional mix, as you are aware that China New Equipment is a higher-margin market for us. And even last year, in 2022, the other markets did little bit better than China. But if you look at 2023, we are guiding for China to be flat; whereas Americas, EMEA to be up mid-single-digit; and Asia mid- to high-single-digit. So, that adds a little bit of a regional mix impact.

But the more bigger mix impact is coming from project mix. And over the past two or three years and, yeah, as you've seen us making announcements on, we won a lot of major projects. Part of our share growth strategy has obviously been on the volume, as well as looking at different verticals, be it infrastructure, others, to grow our major projects.

And the major projects are – they definitely come in with very good maintenance business, very high stickiness, very good margin, but they are lower margin than the volume business. So, there's little bit of that impact in our healthy backlog that we have of 11% as we go into 2023 and beyond.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Makes sense. Thanks for the detail. I guess [ph] I'll ask my few (00:46:01) questions, but I did want to ask a question on – you called out 800,000 connected elevators today. How much of those are Otis ONE connectivity? I want to say about half, but clarify that.

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

A

I think that's accurate, about half.

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Nigel Coe
Analyst, Wolfe Research LLC

Q

Yeah, great. Thanks, Judy.

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

A

You bet.

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

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hey. Good morning.

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

A

Hey, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Sorry, I think you called me, I was – we had got some other calls going on this morning, so you overlapped. Sorry about that. Can we just get a little bit more info on attrition or retention, maybe a little more precision around how much that may have improved year-over-year? Obviously, 1%'s a lot, so there's some nuance there. Maybe just little more precision on that, on the 94%.

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

A

Yeah, so if you – yeah, we've got a – there's a chart in the back. And Steve, we've shared that we – our focus is having a net positive net churn between retention and recaptures. Retention, they're the most important units to us, we get them at the highest margin, and that's where we want to start that individual customer relationship that we hope lasts decades into modernization and then into – just for decades. So, it's at 94%, it's about aligned with last, with 2021. I'd say it's pretty close in terms of retention and recapture, that was up.

And you can see that slightly but it was up healthy, and that was really driven by few items. One – two I'll call out. One is our sales specialization where we actually have recapture sales reps, but that is all they do and they focus on the density and capturing the best – the optimal units for Otis because we have to go in at a lower price than we would at a normal conversion, but we want to make sure that they are accretive. So, the recapture specialist really – we saw them hit their stride as we went through 2022.

And the second is Otis ONE. And in that capital investment, we continue to make, at the data level on connected units and on offering that when we do go recapture, that really makes a difference to our customers. I've personally been involved in a few of those sales calls to win some portfolios back, and it really makes a difference. We can share them the visibility they have, their dashboard they're going to have, and whole ecosystem we offer. And so, those two combined have really helped and that's really the – that's been our strategy and it's going to – what we're going to continue doing.

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C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

And then, just on the attrition in China, I know it's a growing part of the installed base but any trends there worth calling out?

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

A

I think it's a pretty consistent with 2021, is what I would say. We didn't see huge anomalies. Obviously, it's – our portfolio in China, our Service portfolio, I think we've shared, is a little over 325,000 units and that's grown. It's our sixth straight quarter of mid- to high-single-digit portfolio growth in China. And so, we're continuing recapture; we did well there. So, we're continuing to monitor that but our teams – our Service teams in China are continuing, again, six straight quarters. And, yeah, we expect – because of the growth in that segment, we can – we expect that to be in the teams again for 2023.

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

A

[ph] Exactly. (00:49:59)

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Great. Thanks. Judy, thanks a lot.

Operator: Thank you. [Operator Instructions] And our next question comes from Miguel Borrega with Exane BNP Paribas. Your line is now open.

Miguel Borrega
Analyst, Exane BNP Paribas

Q

Hi. Good morning, everyone. I've got a couple of questions. The first one, on your margins for New Equipment in China, I know that you don't disclose this, but can you give us some color on how this has evolved over the years? How does your margin compare to [ph] guide (00:50:39) versus, for example, pre-COVID level?

And at the moment, what is the direction of travel for margins on new orders? And then, maybe longer-term, can you give us a sense why margins in China will keep being much more profitable than, for example, Europe or the US? Thank you.

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

A

Okay. I think there were three questions over there. So, let me start with the China New Equipment margin. Yeah, we don't disclose margin by regions. If you look at China New Equipment, it is slightly higher. It's a good margin business for us. Importantly, if you look at even last year, with all the volume decline, the commodities headwinds that we faced, we were still able to mitigate a significant amount of that through productivity.

So, the margins of the New Equipment business have actually held quite strong because of the productivity business. And even this year, if – where we are guiding to – our margins to be, we're almost back to 2021 levels despite volume being flattish or slightly down. China volume being down 10%, and as – going through a

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commodity headwinds of about $150 million to $180 million. So, clearly, the margins are trending in the right direction.

And all I would say is that we're quite happy with the way we've been able to mitigate some of the headwinds to get to where we are right now. Yeah. So, that's on the first question regarding where our New Equipment margins are.

Backlog is trending up. The backlog margin is trending up. We've had price increases over the past couple of quarters. If you look at where we're exiting this year – in 2021, our backlog margin declined by 1 point. We are above 1 point right now. And we – where commodities are and where are pricing, new orders and new proposals are going in, that backlog margin should kind of inch up as we move along through the course of the year. We, again, don't give specific guidance on where it would be but it's encouraging to see the price kind of sticking in the market over there.

Yeah. And, sorry, what was the third question? I couldn't quite get the question completely. If you could just repeat that, Miguel?

Miguel Borrega
Analyst, Exane BNP Paribas

Q

Well, just give us a sense on the spread between margins in China and the rest of the world, why shouldn't we see some kind of conversion trending down to more like Europe or the US?

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

A

Mature versus China.

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

A

Yeah, it's still accretive for us in terms of the margins over there when you keep driving productivity. So, it will, on the strategy that we're kind of embarking upon, be it digitalization or productivity, we should see the margins kind of inching up. I mean, net-net, on the Service side, we're seeing 50 basis points margin expansion this year, which is on the high end of our medium-term guidance and, obviously, margins will differ by region, by country. But with all the tools we are doing, we see margin expansion across all the regions.

Miguel Borrega
Analyst, Exane BNP Paribas

Q

Thank you. And then, just one last question on free cash flow conversion. I want to get your views not only on 2023, but also little bit further away, where do you see this normalizing? Because 2021 was 128%; 2022, 115%; and now, you guide between 105% and 115%. Is this basically China contributing less working capital? And do you see that improving in 2023 with more financing to real estate developers? Maybe if we can get some of your color what's going on on the ground in China today, do you see any improvements there? Thank you very much.

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

A

Yeah, so let me take that. Actually, our working capital in China, our collection is progressing quite well. If you look at this 2022, we finish at about 115% of net income, which it was quite good. We had a very strong fourth quarter. We came in a little bit lighter, was because of the inventory that we built up to make sure that we can

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support our backlog as we get into 2023. Between receivables and payables, we're pretty much there. So, it was more of the inventory buildup.

Now, what we're guiding at the midpoint for 2023 is a 110% of net income. It's essentially driven by earnings growth with a little bit of a modest offset from capital expenditure as we're embarking on our Otis ONE strategy. So, that's takes us to 110% net income. And as we move forward, we should grow our cash with earnings and that's what we've kind of guided towards, and you should see that normalizing around 110-ish percent level.

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

A

Yeah. And Miguel, just let me wrap on that but, I mean, this is – that was our medium-term guide that we gave at the Investor Day in February of last year and that – so, we beat it in 2022 and we're staying consistent right now with our guide with the Investor Day.

Miguel Borrega
Analyst, Exane BNP Paribas

Q

Thank you.

Operator: Thank you. And I'm currently showing no further questions at this time. I'd like to hand the conference back over to Ms. Marks for any closing remarks.

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

Well, thank you, Norma. Our success in 2022, our third year in a row of performing for all stakeholders, demonstrates strategic resiliency of our business and provides us with confidence as we begin a new year. Supported by strong industry dynamics, we remain committed to our strategic pillars in order to deliver for our customers, shareholders, valued communities, and the riding public. We set significant goals for the year ahead and we look forward to sharing our 2023 success with you. Please stay safe and well. Thank you.

Operator: This concludes today's conference call. Thank you for your participation. You may now disconnect. Everyone have a wonderful day.

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