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Otis Worldwide Corp. (OTIS)

Q1 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to Otis's First Quarter 2020 Earnings Conference Call. This call is being carried live on the Internet and recorded for replay. Presentation materials are available for download from Otis website at www.otis.com.

I'll now turn the call over to Stacy Laszewski, Vice President of FP&A and Investor Relations.

Stacy Laszewski

Vice President, FP&A & Investor Relations, Otis Worldwide Corp.

Thank you, Angela. Good morning to everyone. Welcome to Otis's First Quarter 2020 Earnings 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 other significant items. The company will also refer to adjusted results where adjustments were made as Otis was a standalone company in the current period and prior year. A reconciliation of these measures can be found in the Appendix of the webcast.

We also remind listeners that the presentation contains forward-looking statements which are subject to risks and uncertainties. Otis's SEC filings, including its registration statements on Form 10 and Form S-3 and its Form 10-Q provide details on important factors that could cause actual results to differ materially.

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

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Judith F. Marks

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

Thank you, Stacy, and good morning everyone. We hope that everyone listening across all of our stakeholders is safe and well. We're glad that you could join us today on Otis's first earnings call post spin, another important milestone for us in this new era as an independent company.

Before I discuss our first quarter results and Otis's outlook, let me share some insights into our people, our business, our management through this crisis and more importantly, our commitment to our long-term strategy and values. Employee health and safety, a core value, is first and paramount to us. I am proud of our 69,000 colleagues who are supporting our customers and the riding public during these unprecedented times. Elevator maintenance and repair was deemed an essential service in most countries and cities and we continue to service the largest global maintenance portfolio, including elevators in hospitals, critical infrastructure and residential buildings. And we're doing this while prioritizing and paying utmost attention to ensure the health and safety of our workforce around the world, allowing many employees to work from home and providing the proper PPE and guidelines for safe and hygienic working conditions for our colleagues in the field and our manufacturing operations. Early in Q1, we made critical decisions to ensure business continuity and this helped us navigate the COVID-19 impacts; first in China and many countries throughout the world.

Today, all 14 of our principal factories are open. Our supply chain team has done an excellent job locally and globally in minimizing disruptions to our factories and our field sites while meeting customer demands. Our decision to airship critical parts early during this outbreak has enabled us to protect the supply chain and we're confident that Otis factories around the world are ready to manufacture at full capacity as soon as jobsite demand resumes and businesses start to return to normal. During this time, we've extended support to our vendors where necessary, providing advances to limit supply disruptions. Let's discuss the New Equipment segment by region. China has seen substantial recovery within the quarter. At this point, China factories have returned to full capacity and access to China new equipment jobsites is returning at varying pace by city to pre-COVID-19 levels. In Asia-Pacific, we're installing new equipment in several areas, including Japan, Korea and Hong Kong, while the currently hardest hit areas are India and certain countries in Southeast Asia, where our access to jobsites is limited and there are labor shortages due to government-imposed measures. North America and EMEA continue to experience jobsite closures in certain areas and cities that are preventing the installation of new equipment and we are monitoring the situation closely as jobsites reopen.

Moving to Service, as I mentioned earlier, elevator maintenance and repair was deemed essential in most areas, allowing Otis's service professionals to provide critical maintenance for our customers. Maintenance and repair made up 80% of Otis's Service sales in 2019 and our maintenance business remains resilient, while we are experiencing some pressure on our repair business, where buildings are shut down. Our field professionals continue to support round-the-clock service at hospitals across the globe. In North America and the EMEA, we have seen a greater need to support a few limited customers within the hardest hit verticals, with delayed payment terms and concessions during building closures. We will continue to strengthen our long-term customer relationships. Modernization, the other 20% of our Service business, is expected to see impacts from COVID-19 as discretionary projects are put on hold, especially in North America and Europe. However, some co-driven and technologically required modernizations are driving activity in Asia Pacific and other regions.

Across our business, we've responded with cost containment options to address the evolving situation and associated sales declines. Our China team was focused on immediate actions, which did minimize the first quarter financial impact. Cost containment actions already underway include global hiring freeze, reduction in travel and other discretionary costs, merit and salary deferrals, reducing executive pay and furloughs in certain locations. These are difficult, but necessary actions and our team continues to assess and adjust to address the

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evolving situation. This crisis has also shown us that our OTIS absolutes: Safety, Ethics & Quality, drive our commitment to each other, our customers, our passengers, our investors and to the communities where we live and work. In multiple countries across the world, we used 3D printing technology to manufacture face shields for use by our teams and by frontline workers and hospitals. In Wuhan, beyond providing uninterrupted elevator maintenance, we donated elevator cab air purifiers to several hospitals.

And lastly, we pledged financial employee contributions to COVID-19 relief funds. And our colleagues continue to volunteer local communities in many ways. As the world reopens, we will continue to innovate and lead our industry. We're leveraging technology to allow smartphones to interact with elevators for remote floor selection and providing disinfectants and fans to assist in a cleaner environment and services for elevators and escalators. We're working closely with many customers who have requested elevator adaptations as their buildings reopen and people returned to work locations and we will do all of this while investing for the long term.

Now, let me turn to our first quarter results on slide 4. As you've seen from our earnings release yesterday, the first quarter was a solid start for Otis in spite of the initial COVID-19 outbreak in China and the subsequent global spread. On April 3, we successfully separated from United Technologies, returning to our roots as an independent company, while exemplifying various elements of Otis's culture, our innovation, empowerment and collaboration. Over 200 IT systems were replicated, more than 600 procurement and IT contracts [ph] resigned (00:07:56) and almost 500 processes cut over, we created several new departments including Tax, Treasury, Investor Relations and executed nearly 50 facility moves in 18 countries. I'd be remiss if I didn't once again thank our team for this historic undertaking, rising to the occasion and setting us off on the right foot as an independent Otis.

In terms of liquidity, we had approximately $1.4 billion of cash at the time of separation and have an undrawn $1.5 billion revolver, which serves as a backstop to our commercial paper program. During the first quarter, we placed over $6 billion of debt at favorable rates; that led to a $30 million reduction in interest expense from our initial expectations. We announced a Q2 dividend yesterday of $0.20 per share and plan to return $260 million to shareholders through dividends in the balance of the year. Q1 results continued the strong operational momentum that you saw during 2019. New Equipment orders increased 5.6% at constant currency, excluding China, with double-digit growth in the Americas and mid-single-digit growth in the EMEA. Organic sales declined slightly, excluding China, where top line growth was significantly impacted by the COVID-19 outbreak. Adjusted operating profit increased $17 million and we achieved margin expansion in both the New Equipment and Service segments, with 120 basis points of margin expansion overall. Free cash flow conversion was 73%, including the impact of spin-related tax prepayments. I'm pleased with the strong first quarter results despite the impact from COVID-19. However, we are not immune from a broader economic impact as this pandemic spreads across the globe.

With this in mind, we are updating our 2020 outlook. We now expect organic sales to be down 3% to 7%, reflecting recovery beginning in early Q3 at the high end and a delayed second half recovery at the low end. Adjusted operating profit is expected to decline $25 million to $175 million at constant currency, reflecting volume declines, partially offset by cost containment actions I previously described. We expect adjusted net income to be in the range of $840 million to $940 million. This net income outlook reflects the reduction in interest expense and a one-point adjusted tax rate improvement from our expectations in February. And lastly, we expect free cash flow conversion to remain strong between 110% and 120% of 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.

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Thank you, Judy, and good morning everyone. Starting with Q1 results on slide 5. Net sales were $3 billion, down 4.4%, with slightly less than half of a decline coming from organic sales and the rest of the impact of foreign exchange and net divestitures in 2019. Strong organic sales growth of 3.3% in the Service segment was more than offset by a 9.8% decline in New Equipment, due in parts to COVID-19. Adjusted operating profit was up approximately 4% or $17 million and up $27 million at constant currency. Operating profit growth at constant currency was driven by approximately $45 million of operational improvement from higher service volume, strong material and service productivity, lower SG&A and transactional foreign exchange favorability.

This was partially offset by the impact of COVID-19 that reduced operating profit by an estimated $17 million due to lower volume and under-absorption of costs. Adjusted operating profit margin expanded 120 basis points to 15.2%, with margin expansion in both New Equipment and Service segments. R&D as a percentage of sales was flat versus prior year and adjusted SG&A expense improved by about $30 million in the quarter.

Adjusted EPS was down $0.02 as a $0.04 to an improvement from operating profit and lower net interest cost was more than offset by $0.06 of headwind from tax, due to an unfavorable year-over-year compare in the quarter and higher non-controlling interest costs.

Moving to slide 6. New Equipment orders grew 5.6% at constant currency, excluding China and were flat overall for Otis. New Equipment orders grew double digits in the Americas, mid-single digits in Europe and the Middle East and declined low teens in Asia, including China. This strong order growth was delivered in a global market that was down mid-single digits, excluding China and down mid-teens globally as the China market declined an estimated 20% in Q1.

New Equipment share continued to grow and was up an estimated 25 basis points in the quarter. While the overall bookings were down in Asia, we continued to see progress in the infrastructure segment and received several key orders, including for the Chongqing and Nantong metro projects in China.

As we discussed on Investor Day, this is one of our key target segments and our infrastructure bookings grew high-teens in a segment that was down low double digits. We also saw pricing stability in most parts of the world, with 80 basis points of booked margin expansion. Booked margin expanded in EMEA and China and was offset slightly by the pressure in Asia outside of China. Americas booked margin was flat. Backlog was up 3% at constant currency in the quarter, with growth in Americas and EMEA offset by a low-single-digit decline in China. Organic sales were down 9.8%, with double-digit declines in Asia, including China, primarily from the impact of COVID-19. Sales in Americas declined 9%, reflecting a tough compare and the impact of lower order intake in Q1 of 2019. Sales in Europe were up low single digits. But this was more than offset by weak results in Middle East due to market softness. Overall, New Equipment sales in EMEA were down 3%.

New Equipment adjusted operating profit margin expanded 80 basis points, a strong material productivity and a small benefit from lower commodity prices was more than offset the impact of volume decline. Material productivity in the quarter exceeded our long-term target of 3%, reflecting the benefit of the actions that we are taking. Service segment results on Slide 7 remained strong in the first quarter. Modernization orders grew 2.5%, with high-teens growth in Asia outside of China and Europe, primarily offset by a high single-digit decline in the Americas. Our maintenance portfolio grew by 1%. Organic sales increased 3.3%, with modernization sales up 6.8% and maintenance and repair sales up 2.5%.

Adjusted operating profit margin expanded 20 basis points and profit grew by $14 million at constant currency, as strong productivity, favorability stability in price and mix and lower SG&A expense was partially offset by higher labor costs. Service contribution expanded for the seventh straight quarter, with growth in all major regions. As we

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close out the first quarter, our operational agenda remains on track and we are pleased with the progress on key initiatives; driving share gain in New Equipment, making continuous progress on service contributions, material cost productivity and containing SG&A costs. However, as the economic activity slows globally from the spread of COVID-19, we are seeing the impact on our business activity in the second quarter, which is highlighted on slide 8, with our New Equipment orders and factory shipments both down in April outside of China after a relatively strong start in the first couple of months of the year. We are also seeing reduction in Service sales in April due to the challenges created by closure of buildings impacting our modernization and repair business. While China activity is recovering, it is clear that the business in China will not be immune to the global slowdown. And as we look at the balance of the year, we need to adjust our revenue and earnings growth expectation that we'd communicated in February, while taking incremental cost actions to offset the impacts to earnings from sales shortfall.

Let me start with sales on slide 9. We now expect overall organic sales to be down 3% to 7% for the year, with a 5% to 10% decline in New Equipment and a low to mid-single-digit decline in Service. The low end or a 10% decline in New Equipment reflects continuation of the first half trend into second half, while the high end or a 5% decline reflects a recovery in the second half of 2020 to 2019 levels. We do expect continued stability in our contractual maintenance business. However, the range of Service sales outlook reflects varying degrees of delay and push out discretionary repair and modernization projects to continue in the back half of the year, depending on the overall macroeconomic environment and the occupancy level of buildings. Adjusted operating profit is expected to be down between $25 million and $175 million at constant currency and between $85 million and $235 million at actual currency. At the midpoint, this reflects nearly $300 million of cost containment actions that Judy alluded to earlier.

Most of these actions are already announced and are at varying stages of implementation. At the midpoint of our sales outlook, we would expect operating margins to be relatively flat. Adjusted net income is expected to be in the range of $840 million to $940 million, driven by a reduced operating profit, partially offset by lower tax rate and non-controlling interest costs. We are reducing our tax rate guidance for 2020 to approximately 32% from 33% at Investor Day and are working on additional products to continue to reduce the rate over time. Free cash flow would remain strong between 110% and 120% of net income as reduction in profit and higher restructuring costs will be partially offset by reduced capital expenditures.

Taking a further look at our organic growth assumptions on slide 10, in the New Equipment segment, Americas is expected to be down mid-single digits to 10%, reflecting the sharp decline we are seeing in Q2 with jobsite closures. The high end or a 5% decline contemplates work resuming in Q3 and growth in the back half of the year. In EMEA, the significant delays and limited access for jobsites in South Europe, the UK, parts of Russia and the Middle East. The EMEA New Equipment business has continued and is expected to be down high single digits to 10%, with the high end of the range reflecting jobsites reopening in pre-COVID levels in Q3 in North Europe and a gradual recovery in South Europe and the Middle East. In China, the New Equipment business is recovering in Q2 and in rest of Asia, activity in Japan and South Korea has held up relatively well. But we continue to face challenges in India and Southeast Asia from government-imposed lockdown measures. We expect the Asia New Equipment business to be down mid to high single digits, depending on the pace of recovery in India and Southeast Asia and the extent of impact of the Japanese and South Korean economies from the pandemic. In the Service segment, our contractual maintenance business has been resilient and we anticipate this business to continue to be stable.

However, there have been delays on discretionary repair and modernization projects, as these projects push into 2021 and we now expect modernization sales to be down mid to high single digits and maintenance and repairs to be down low single digits for the year. Overall, the high end of the 3% to 7% organic sales decline reflects an

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early Q3 recovery globally and the low end assumes first half conditions to continue into the second half figures. Switching to profit outlook on slide 11, at constant currency, adjusted operating profit is expected to be down between $25 million and $175 million year-over-year, reflecting the impact of reduced volume from the COVID-19 pandemic, incremental under-absorption of costs, higher bad debt expense due to deteriorating credit outlook and an impact to pricing, especially at the higher end of the sales decline. This will be partially offset by the cost actions we have taken and will take in the balance of the year.

Foreign exchange is now expected to be a headwind of $60 million for the year versus $20 million that we were expecting in February due to the strength of the US dollar.

Moving to 2020 capital deployment on slide 12. At spin, our net debt-to-EBITDA was about 2.4x, with $1.4 billion in cash. During 2020, we expect to generate between $925 million to $1.025 billion of cash and plan to pay down $250 million of debt and return $260 million to shareholders through dividends between Q2 and Q4 at about 40% of adjusted net income. Approximately $200 million will be spent between non-controlling interest and M&A. We believe these capital deployment plans are prudent during these uncertain times as they allow us to increase the cash on the balance sheet by the end of the year and are consistent with what we announced in February, reflecting our confidence in the cash flow generation capacity of this business.

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

Judith F. Marks

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

Thanks, Rahul. A great start to the year and while the pace of recovery is not known yet, Q1 results illustrate that we are on track to support our investment thesis and long-term strategy. We're confident that Otis will endure and succeed despite today's current challenges and I want to close by reminding you of the strong fundamentals behind this fantastic business.

This is truly an iconic brand in this large industry where we have been the leader. From the medium term, we expect sustainable growth and global share gain in New Equipment to continue to expand on our leading 2 million unit Service portfolio, the heart of our recurring business model where we'll continue to focus on margin expansion through productivity. And in these difficult times, we're going to continue to invest for growth, maintaining a sustainable level of R&D and capital expenditures to ensure that when we all return to our normal lives, we are still at the forefront of technology, driving digital innovations, providing new solutions for our customers and empowering our field professionals with tools to make them more effective. You have our commitment that we'll use our robust cash generation in excess of 100% of net income to create shareholder value. And you saw that with our dividend announcement yesterday.

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

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QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question is on the line of Jeff Sprague with Vertical Research. Please go ahead, sir.

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

Good morning, Jeff.

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

Good morning, Jeff.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Good morning. Congrats on a great start out of the gate. A couple from me if I could, please. First, Judy or Rahul, could you comment a little bit more on what you're seeing on pricing and the potential pressure on bad debts? And is the pricing comment, essentially a New Equipment issue or are you seeing that across the Service business also?

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

All right, Jeff. So, pricing actually, we had a good start to the year. As I mentioned in my prepared remarks, the New Equipment, the book margin actually expanded, we saw that and it was pretty strong across the globe, with small slight pressure in Asia, but outside of that, it was fairly good. So really, really good start to the year. In Americas where we saw some pricing last year, the pricing was stable this year. Europe, we saw good pricing and same thing even in China where the markets were down we were – our book margins actually went up a little bit.

So a good start to the year on the New Equipment site and same thing on Service pricing as well. And the Servicing pricing held up really well in Q1 and we gained a little bit of price in Q1 and we implemented our regularly scheduled price increases that we had planned. Having said that, I mean the situation in Q2 is different. And we're working with our customers in the hardest hit sectors in hospitality, in retail, et cetera that Judy mentioned a little bit in her prepared comments. These sectors make up about less than 10% of our Service installed base and – but these are temporary concessions. And they are for a very specific period of time and we do not expect any long-term impact from these. Also, most of our do customers do understand that we do have fixed costs like our Otis call center and we need to maintain and address service issues even when the buildings are only partially occupied. So that is how the concession requests have been very limited.

And we've addressed each one of them individually. But as we gave guidance, we obviously factored in that these concession requests might increase. Again as I said, we have not seen a lot these, there have been a few and we should address them as one at a time, but in our guidance, we've assumed some impact and especially at the

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higher end of the range and same thing on New Equipment, we've assumed that there is a little bit of pricing pressure in the back end of the year, especially on the new orders. Now most of that will not impact this year, but on the Service pricing, the concessions that we are talking about will come through our results this year.

So, that's what we've kind of guided to, same thing on the bad debt. The results were okay in Q1. There's not a lot of incremental P&L expense. We did take not a lot of incremental P&L expense in Q1. But we have factored some in our outlook at the back end of the year.

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

Yeah, Jeff. This is Judy. The long-term relationships we have with these customers are that we're there for them when times are challenging as well and as Rahul said, the hospitality retail segment is just under 10% for us. I really was pleased, China price mix up for the seventh straight quarter, so New Equipment again although was up, book margin was up everywhere, China again delivering, especially in a COVID-19 quarter. And then on our Service pricing, our revenue per unit was up as well for another quarter. So those indications, again strong performance in Q1 and we're going to continue to watch price in Q2 through Q4.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Great. And maybe just an unrelated second question. Just on tax with a little bit more time under your belt, you have a kind of better idea of what maybe the two or three-year trajectory of the tax rate might be?

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

Again, that's early days Jeff, right. Overall, we feel that we're making progress. I mean our last year tax rate was 34%. We guided to 33% on Investor Day. Now, we are at 32%. And the improvement that you're seeing between Investor Day and now is coming from reduction in the taxes that we have to pay on repatriation of cash. If you recall at Investor Day, we had mentioned that we had about 2 to 3 points of tax headwind because we needed to – we needed to pay tax when we repatriate cash into the US. And that we've able to work on certain projects to reduce that and we are taking incremental actions in early 2021 to maybe take some of our dollar-denominated debt and convert that into euro-denominated debt, so we're taking incremental actions. And beyond that, we are working on several initiatives to structure our business better and to reduce the fact that we pay on high tax jurisdictions. We'll keep updating you as we learn more, but we are in early stages, but I'm confident this rate is going to come down over time.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC
Q

Right. Best of luck. Thanks.

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

Thank you, Jeff.

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

Thank you.

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Operator: And your next question is from the line of Julian Mitchell with Barclays. Please go ahead.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning and [ph] I'd like to (00:29:53) contracts on getting a tricky first quarter out of the way. Maybe one thing that might be helpful is when we're thinking about the recovery slope is just a bit more color on the end market split, Judy, if you'd be willing to provide that, understood that hospitality and retail is sub 10%. But perhaps if you could flesh out maybe some of the other splits or, if not at least give us some context as to how your split might differ from the one that KONE provided a couple of weeks ago just directionally.

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

A

Sure, Julian. Good morning. So, the residential market which obviously is not single family homes, the residential market is north of 50% for us in both of our segments and that tracts the industry overall. That's really where the strength has been coming from and the usage has been coming from that we've been seeing the demand as well on repair is in the residential segment. Other than that, we really don't break these out below that. But as you can imagine, we are talking to a lot of customers as they do rebound and more importantly reopen and come off pause as to how they want their buildings to be utilized, especially in the office and commercial space, whether that's malls or more importantly office buildings. So we've got lots of requests to help with limited spacing. We've got requests to help with additional products. But I think what it does is it reinforces our Compass product, our destination dispatch product, which does allow touch-free utilization as well as improved utilization of elevators. So, it's early days to see where – when the recovery happens and how the world reopens, but we're in significant dialogue with lots of our customers across all segments on that.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thank you for that. And then maybe just a follow-up question for Rahul on the free cash flow, maybe just help us understand that free cash flow pressure in the first quarter and how quickly the free cash flow recovers. And also, I guess I was a bit confused because if I look at the material, I think you have about $975 million of free cash flow guide at the midpoint, I guess excluding NCI, about $890 million of adjusted net income at the midpoint. So it's maybe about 110% conversion on adjusted net, but I think the conversion you present is versus GAAP net income. So just wanted to check that and does that mean that GAAP net income and adjusted net income are broadly similar for the year, even with that big delta in Q1?

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

A

Yeah. Let me, let me – yes, let's start with Q1 cash Julian, so we feel we had a good start to the year despite the COVID-19 situation. So in our Q1 cash, we put forward about $70 million of tax payments from Q2 through Q4 and that was primarily due to the spend. So, that's in our Q1 results; again Judy had it in the prepared remarks. Also we did extend support to our vendors, especially in China and you see that our payables were down about $200 million from December to March. So – and part of this decline was to support getting our supply chain up and ready in China. And this cash flow impact should get mitigated between Q2 and Q3. But despite the impact that we saw in China, our working capital actually came down by about $30 million in the quarter and then we had about $47 million of separation cost. So overall, we feel that we had a very strong performance operationally given the pull-forward of tax payments, the impact that we saw in China given the support that we had to extend this to our vendors and then the separation costs. So, working capital coming down, so overall we feel really good about how our business performed on cash given the overall environment.

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Now, what you will see and going back to your second question on how this kind of translates into the rest of the year? Now, Q2 is going to be a little bit challenging in Europe and China – Europe and the US. China is going to recover, but we will see some pressure in Q2 in Europe and the US and then so our cash flow will be a little bit more skewed towards Q3 and Q4 than it typically is, but you would expect that given the overall macroeconomic environment. But we feel good about our guidance. I think we've done – we've taken good steps to offset and mitigate some of the impact that is coming through from the drop in net income from our previous guide to this guide. I mean, if you look at the guide-to-guide on our net income, it's probably down at the midpoint at AFX about $150 million and we've mitigated that through lower CapEx. We've reduced our interest cost. There's some tax payments that we're trying to manage, some of that coming through the [indiscernible] (00:34:52), but we're trying to put all that in and yet drive $975 million of cash as kind of the midpoint. So we feel good about our backend recovery and cash flow.

Now, on the conversion question, you're right, Julian. It is about 110% on our reported net income basis, but the guide that we have provided to includes some of that cash that will outflow on the separation costs, the PSA payments that we will have to make to UTC; so we factor that in and some of the restructuring that we've taken and the restructuring has actually gone up year-over-year as well. So that reflects some of the impact on that, so adjusting for some of the one-time expenses we will have, the number is between 110% to 120% and we've excluded any non-cash one-timers, like [ph] there were (00:35:40) asset write-off that we had in Q1, we've excluded that from the calculation. So it is purely on the GAAP net income, adjusting for any non-cash charges that we will have. So that's the guide, that's the range of 110% to 120% and the adjusted net income which we'll speak to, that's at a 110% at the midpoint.

Julian Mitchell Q
Analyst, Barclays Capital, Inc.

That's perfect. Thank you for the color and reply.

Operator: And your next question is from the line of Steve Tusa with JPMorgan. Please go ahead.

Steve Tusa Q
Managing Director, JPMorgan Securities LLC

Hey guys, good morning.

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

Good morning, Steve.

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

Good morning.

Steve Tusa Q
Managing Director, JPMorgan Securities LLC

Just to clarify, that $70 million tax payment is kind of part of the – is that part of the separation and you're including that in the $975 million?

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

A

No, it's not part of the separation, Steve, it got pulled forward into Q1 because of certain spin-related – consequences of spin, let me put it that way. So that's what [indiscernible] (00:36:38) some things it's complicated. But the reality is no impact of full year, it got pulled forward into Q1 due to the spin. So that's...

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

All right. But so, I guess like your cash tax rate is kind of consistent this year with what you would expect going forward is the point, absent any of the moves you're going to make strategically on your GAAP tax rate.

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

A

For full year, it will have no impacts to our cash taxes, right. So that it...

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Right, right. So it won't be a tailwind next year is your point.

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

A

No, it won't be a tailwind next year.

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Got it. Okay. That makes sense. When you talked about the pricing dynamics, so you kind of bounced back and forth between Services and New Equipment. How should we think about that breakout? Is there a heavier weighting to one or the other? I mean, you talked about kind of helping some customers out; that seems like it would be more of a Services dynamic; maybe if you could just like flesh out if there is more of a weighting to one or the other?

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

A

Yeah. So in terms of the retail – the concessions we've made, those are for our services, mainly in the hospitality industry, mainly in the US, Steve, just so you understand.

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Right.

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

A

Our China team was able to really work through this very rapidly and obviously, these are the long-term partnerships and we're being a responsive partner and supplier. But as we look at booked margin on the Service side, it was up fairly significantly, mainly in EMEA and China. And then, it was up more significantly than the New

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Equipment booked margin was up, but the New Equipment book margin obviously it drives our $16.5 billion backlog fairly substantively over the ensuing 24 months. So any time we can get that booked margin up on orders, be it in China or anywhere else in the world, it's a nice rolling tailwind for us as we look into the next year's sales.

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Okay. Got it. And then one just last question on the second quarter, if you look back to last year, pretty punchy number for New Equipment margins. You had pretty significant, I think, mix kind of tailwind; maybe that was China flowing through. So, the year-over-year comp there looks kind of tough. Maybe if you could just give us some kind of sequential color on to kind of calibrate everybody for what's coming here in the second quarter, acknowledging that things will kind of bounce back or bounce around in the second half? Are we, from an EPS perspective, can we be down as much as kind of 30% to 40% sequentially 1Q to 2Q?

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

A

Yeah. So we don't comment on specific numbers, Steve, but you're right. I mean, the Q2 is probably going to be our toughest quarter, without a doubt. I mean, you see what's happened in April and we've seen some recovery in May obviously as things begin to open up. But April was a really tough month for us and you saw that from the data that we put out there. So we do expect a fairly sharp decline in organic revenue year over year and so it'll be more so on the New Equipment side for – and then less on the Service. And then the Service is going to be mainly on modernization and repair, but the New Equipment side is going to be impacted substantially in Q2. So that is what we're expecting. So you're right in terms of modeling; obviously we had a good start to the year. Q2 should kind of – maybe kind of offset some of that and then we see a recovery on the New Equipment side starting to happen in the back half of the year.

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

A

So Steve, let me try and add some...

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Yeah. So new Equipment Margins will be down quarter-to-quarter or can you hold those flat?

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

A

New Equipment margins could be down quarter-to-quarter. We're not going to give specific guidance, but yeah...

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Got it.

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

A

...they could, given what we see and all depends on perhaps the reason we're hesitating, Steve, a little bit is that all depends on how the recovery is in June. If we're coming out of the gate, if the jobsites begin to open up and

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we are able to get quickly to work and we resume activity, it could be a little better. So that's where we hesitate because it just is the – the near-term outlook is kind of not very clear at this point. So that's where we're kind of [indiscernible] (00:40:52) a little bit.

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Yeah. Makes sense.

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

A

Yeah. Steve, we really are watching – our jobsites, the pace at which jobsites are opening very carefully and we're monitoring it almost on a daily basis in the regions. But when you look at a company – a country that was in lockdown like Italy, the jobsites are now almost 35% open. In Spain, almost 90% open. And so we're really seeing the construction part of that new – which is the main element of New Equipment, obviously other than the manufacturing, is the installation and construction piece. It's that speed of recovery that we're trying to watch and calibrate and monitor for 2Q.

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Yeah. Makes a lot of sense. Thanks a lot. Appreciate the detail.

Operator: And your next question is from the line of Carter Copeland with Melius Research. Please go ahead.

Carter Copeland
Analyst, Melius Research LLC

Q

Hi. Thanks for the time and welcome to the independent world. And your first conference call is great, great set of results.

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

A

Thanks, Carter.

Carter Copeland
Analyst, Melius Research LLC

Q

Just a couple of quick ones. One, Rahul, I wondered if you could give us a little bit more color on the cost-out actions and how much of that is temporary, things like furloughs versus anything that might be run rate as we look further into the future? And then one for Judy, just wondering about the impact of this whole thing and the change that it may bring on the competitive landscape on the Service side, just given your scale benefits versus ISPs. I mean I would assume you can bring much more to bear in terms of Service performance and reliability. I just wondered if you might give us some thoughts on that. Thanks.

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

A

Yeah. Good morning, Carter. So obviously, as you would expect that at the midpoint of $300 million of cost takeout actions that we have planned for, it's a combination of both. I mean it's a combination of structural actions. It's also a lot of those short-term actions that we are taking that Judy mentioned, including furlough, merit

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deferrals, so it's a combination of the two. And if you see our restructuring number, we upped that to $70 million to $80 million, we spent about $50 million to $60 million last year, so it's incrementally higher. We are looking at our structural costs at a very, very hard way, looking at where duplication of work is happening, pulling that out.

So, we are taking a lot of hard restructuring actions, as you would expect us to. So, that's a piece of the cost takeout, but lot of these actions may have more limited impact in 2020 and probably help us in 2021 more than they help us in 2020. In 2020, a lot of the benefit that you will see come through is going to be from the short-term actions that we are taking. So that includes merit deferrals, that includes furloughs and executive pay reductions, all the things that you would expect us to do and we're going to watch this thing very carefully and it depends on whether – how this translates into 2021, depends on how the revenue comes back and our goal will be to ensure that we take enough structural costs out to mitigate the impact of any one-time headwind that we would get from these actions that we're taking.

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

A

Let me address your second question, Carter, on impact to Service. We've looked back and modeled the global financial crisis to understand what transpired there. And for those of you that covered Otis as part of UTC back then, you'll recall we had a 10 percentage point, not just 10 basis point, 10 percentage point higher ROS than our local – nearest competitors. The two biggest differences that we're seeing coming with COVID-19 right now in 2020 are the precipitous building closures, which are having an impact not just on the construction side, but on our access for repairs, especially discretionary repairs. We did not see this during the global financial crisis and the other key element is there's no oversupply right now of the skilled technicians and field professionals, which we did have back in the global financial crisis. So we have worked extremely hard to maintain; we have 40,000 service – field professionals, 33,000 service to make sure that working with our workers councils, our unions that we have retained and are engaged with our field workforce because this is a labor business and they are the strength of our company to drive all of our servicing globally. We have the liquidity as well, which some of the ISPs won't have.

So, we see the dynamic changing, we've started a recapture campaign while our sales forces are mainly working from home to be able to grow our portfolio and to get some of our customers back who may have left us for ISPs over the years. And then we have sustained our investment in our Otis ONE IoT offering so that we'll continue to have both technological as well as transparent and predictive information to be able to provide service in a more productive way and a better way for our customers. So, I actually see Service coming out of this once we get through the discretionary delays. I don't think they're a demand issue. It's really a delay issue. And once we get through those, we see service having the potential to accelerate.

Carter Copeland
Analyst, Melius Research LLC

Q

Great. Thank you for the color.

Operator: And your next question is from the line of Cai von Rumohr with Cowen. Please go ahead.

Cai Von Rumohr
Analyst, Cowen & Co. LLC

Q

Terrific. Thank you for taking the question. So you mentioned the 60% of your base resi and retail hospitality. What's the other 40%? How is it split between infrastructure, hospitals and commercial office? And are you seeing any weakness there, specifically commercial office? Thank you.

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

A

Yeah, Cai, this is Judy. We don't disclose the segments that way, the end markets that way. I can tell you our infrastructure business is continuing. Obviously it's a broad-based business, great success in China as well as the rest of the world. But obviously, linkage to what's happening in the aviation market because not only do we support metros and rail and stadiums, we also obviously support airports. All that maintenance work is continuing in our Service business, but there are several large bids that are still underway for airport modernization that we think it's going to be demand delay as well. But again, we don't break those out specifically.

Cai Von Rumohr
Analyst, Cowen & Co. LLC

Q

Great. And then a second one. On the concessions, I mean given that you're the strongest service population in the Americas, where there have been grants for concessions in the hospitality section and retail. Are you seeing that trend getting worse and what does that imply for Service margins in the second quarter relative to the first?

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

A

The trends are not getting worse, Cai. We did, as you would expect, that we've been working with our customers to make concessions where they're applicable, where the industries are hurting. Judy said we do believe in longstanding relationships with customers; so we have to react and share some of the pain that they are suffering. So, that was where we came out and we made certain concessions that are tied and limit to a certain price – certain time period. So that's where we worked; now it's not getting worse. You'll see some impact from that in Q2 and some of that may spill over into Q3 depending on when those concessions started. But it's for a very, very limited period of time and it's going to be spread between Q2 and Q3.

Cai Von Rumohr
Analyst, Cowen & Co. LLC

Q

Terrific. Thank you very much.

Operator: And your final question is from the line of Nigel Coe with Wolf Research. Please go ahead.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning. Last question, so I better make this a good one. So look, turning to the profit bridge, that COVID-19 bucket, the $250 million (sic) [$260 million] (00:49:20) to $515 million buckets, I mean, obviously that includes price, bad debts, under-absorption and of course, volumes. But when you think about the [indiscernible] (00:49:29) volumes, decremental margins we should expect for New Equipment and for Service; how do we think about that? I mean, how does that break out between the two segments?

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

A

So the way I would think about this, Nigel, and the question – your question is always good, right. So it doesn't matter whether it's the last one or the first one. So, in terms – so if you look at our disclosures that we have made, our contribution margin on New Equipment averages between, depending on the quarter, about 17% to 18%, right, so that's our overall contribution on New Equipment. And the Service side, it's obviously higher. And so, overall if you look across the entire business, that averages out to about 25%-26% contribution margin. But then

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there is some under-absorption of cost when the revenue decline is as sharp as what we've seen this year just, especially on the Service side because the fact is in Service, we primarily use our own technicians to service the elevators and modernize those elevators; so that's where we [indiscernible (00:50:32) see some incremental pressure because of under-absorption of costs.

So that's what we've kind of modeled in that bucket; it's that contribution margin, plus there is an incremental impact from under-absorption of cost. Now, we are working to offset that and that you see some of that on the – in the green bucket. As we spoke about, we have taken action wherever we could to reduce that under-absorption to – whether it's through restructuring actions or through furlough. So we are taking actions to reduce the under-absorption. So we kind of – one's in the left, the other one is in the middle of the page. So that's what that is. So overall, you should think about 25% of our contribution margin, plus an additional impact from under-absorption.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. That's good information. And then just a couple of quick ones here. So the outlook for – the Service outlook, the low to mid- single-digit declines, you've given some great regional flavor there, but should we expect that most of that, if not all of it, lands in 2Q or you're assuming there could be some declines in 3Q as well?

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

A

Yeah, I think it depends, Nigel, on whether we're going to see the high end or the low end. So on the high end, we think the majority of it is in Q2, but it will continue for the repairs depending on how our access to buildings are and then obviously on the on the low end, we do see it again that whole Q2, second half of the year being far more challenged and it rolling out throughout the whole year.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. And then just a quick one on NCI, a bit stronger than expected, specifically in light of what's China – the performance in China 1Q, so just wondering what drove that higher.

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

A

In Q1 Nigel is your question?

Nigel Coe
Analyst, Wolfe Research LLC

Q

In Q1, yeah.

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

A

Q1 yes, our profit with some of those JVs that we had in Spain and China was better; I mean we did better year-over-year in some of those businesses and that drove a higher payment to our JV partners.

Nigel Coe
Analyst, Wolfe Research LLC

Q

So China JV income was actually higher year-over-year?

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Rahul Ghai

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

A

Again, we don't talk about China specifically, but between China and Spain, that makes up about 75% of our overall income. And that's what's driving – that's what's driving our incremental expense on NCI in Q1, but our China business did very, very well despite the challenges on volume.

Nigel Coe

Analyst, Wolfe Research LLC

Q

Got it. Okay. Thanks guys. And congratulations on getting this ship launched. Thanks guys.

Operator: Thank you. I am showing no further questions at this time. I will now turn the call back to Judy Marks for closing remarks.

Judith F. Marks

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

Well, thanks again for joining the call this morning. During these uncertain times, we remain focused on executing our strategy, managing risks and driving value for Otis shareholders. I want to thank our colleagues for their dedication as well as those on the front line fighting COVID-19. Please stay safe and well and we hope to hear from you all soon. Thank you.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for your participation and have a wonderful day. You may all disconnect.

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