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Otis Worldwide Corp. (OTIS)

Q2 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to Otis' Second Quarter 2021 Earnings Conference Call. This call is being carried live on the Internet and recorded for replay. Presentation materials are available for download from Otis' website at www.otis.com.

I'll now turn the call over to Michael Rednor, Senior Director of Investor Relations.

Michael Rednor

Senior Director-Investor Relations, Otis Worldwide Corp.

Thank you, Angie. Welcome to Otis' second quarter 2021 earnings conference call. On the call with me today are Judy Marks, President and Chief Executive Officer; and Rahul Ghai, Executive Vice President and Chief Financial Officer.

Please note, except where otherwise noted, the company will speak to results from continuing operations, excluding restructuring and significant non-recurring items. The company will also refer to adjusted results where adjustments were made as though Otis was a stand-alone company in the current period and prior year. A reconciliation of these measures can be found in the appendix of the webcast.

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

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

Judith F. Marks

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

Thank you, Mike, and thank you, everyone, for joining us. We hope that everyone listening is safe and well. Before we get into the quarter, I'd like to congratulate Mike on his new role leading Investor Relations, and thank Stacy for all the great work getting us to this point. We look forward to seeing you both excel in your new positions.

Otis delivered an excellent second quarter, closing out strong first half. This included mid-teens organic sales growth, demonstrating the resiliency of our colleagues in business and our ability to execute on our long-term strategy. Overall, demand in the New Equipment segment was strong. We gained about 1 point of New Equipment share, with orders up approximately 24% in a market that was up low-teens.

New Equipment orders grew in all regions and were particularly strong in the Americas, up nearly 50% with an over 4 times increase in major project bookings versus the prior year. These orders will support customer projects throughout North America; for example, in Canada, Otis secured an order to outfit a luxury high-rise condominium building in the M City community with several elevators, including custom cabin interiors, that fit the building's upscale design.

Moving to Service, we grew sales in all lines of business, including repair and modernization. Modernization demand was strong with orders up mid-teens versus prior year. This include another Otis partnership with Silverstein Properties in the Americas where we will modernize more than 40 elevators in the U.S. Bank Tower in Los Angeles and integrate Compass 360 and Otis' eCall app to allow for more seamless customer and tenant access to the building services.

The demonstrated strength of the maintenance business continued and we achieved 3% growth year-over-year on our industry-leading Service portfolio, a key goal we set for ourselves entering this year. We drove profit growth and margin expansion in both segments, largely from the benefit of higher volume as New Equipment and Service organic sales grew about 25% and 8%, respectively.

Since spin, our consistent performance reflects the power of our strategy and its implementation. I hope many of you were able to join us for Welcome to Tomorrow where we shared our Gen3 and Gen360 highly innovative platforms that meet the current and future needs of our customers in an increasingly connected world.

Gen3 built upon the proven flat-belt technology of Otis' best-selling Gen2 platform, while adding built-in Otis ONE IoT connectivity and a variety of options such as eCall, eView compass dispatching systems, health solutions, and updated aesthetics. APIs allow us to access and leverage data with analytics that drive value for our customers. Upon release, Otis secured an order for more than 100 Gen3 elevators for a new residential project in the Jilin province in northeast China.

In EMEA, after successful pilots in several countries, Otis officially launched Gen360, a next-generation, digitally-native platform that includes all the features of the Gen3 elevator built around an all-new electronic architecture in a more compact design. Gen360 is enabled with IoT capabilities and online tools, a connected passenger experience, and additional safety features to help limit entrapments and enable maintenance from inside the elevator cab. In France, Otis was selected to outfit a future aquatic center in the Paris suburbs with the Gen360 ecosystem.

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In addition to its many digital safety and passenger benefits, this platform has a decisive advantage. For the first time, we can eliminate the need to accommodate hoistway projection onto the roof, avoiding interfering with the building's architecture lines, a feature desirable to architects and building owners.

All of this strong first half performance, including robust free cash flow generation in excess of 150% of net income, enables us to return additional cash to shareholders. In the second quarter, we completed the previously planned $0.5 million in share repurchases ahead of schedule and are now in a position to increase our 2021 target to $750 million.

In parallel with the strong financial performance, we continue to make progress on our ESG initiatives that are integral to bringing our vision to life. In May, we released additional long-term ESG goals aligned with our four ESG commitments: health and safety, people and communities, environment and impact, and governance and accountability.

During the quarter, we made progress on our goal to meet ISO 140001 certification standards in all of our factories. Otis' manufacturing facility in Brazil became the latest to achieve this certification, meaning nearly 90% of our factories are now ISO 140001 certified. This is part of our ongoing work to operate more sustainably.

Initiatives in the factory include implementation of rain water and water reuse systems; LED lighting to reduce energy consumption by more than two-thirds; and improvements to shipping and packaging materials to reduce waste by approximately 800 tons annually. In Paris, we introduced electric vehicles into our fleet and we'll be expanding this pilot over the coming months. Early feedback from our field professionals has been positive and the program will continue to contribute to our CO_2 emission reduction targets.

Moving to social. One year ago, in response to the urgent problems of social unrest and entrenched racism, we announced our Commitment to Change, a framework to ensure all colleagues feel safe, welcome, and heard. While there's still work to be done, I'm proud of the progress we've made on this initiative over the past year. Actions taken include engaging all supervisors worldwide in a training program designed to help them mitigate unconscious bias, increasing access to employee assistance and wellness programs globally, launching our Made to Move Communities' signature STEM education program, and awarding not-for-profit grants to communities in each region that support diversity, equity and inclusion programs.

And in June, we began our second annual Season of Safety, reinforcing Otis' strong safety culture; recommitting to our life-saving Cardinal Rules; and prioritizing ongoing training on safety procedures and protocols. We remain committed to a zero-harm workplace.

Now turning to slide 4, second quarter results and 2021 outlook. In addition to record New Equipment bookings in the second quarter, total Otis orders were up 9.4% on a rolling 12-month basis. Organic sales were up 15.4% in second quarter with 25.4% organic growth in the New Equipment segment and 7.8% organic growth in the Service segment.

Adjusted operating profit was up $115 million and margin expanded 40 basis points, despite a 60-basis point impact from segment mix as the New Equipment business grew faster than the higher-margin Service business. Free cash flow was robust to $493 million with 151% conversion of GAAP net income. This positive momentum, our continued progress on our long-term strategy, and the pace of recovery in our end markets gives us confidence to improve our 2021 outlook across all key metrics.

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We now expect sales to be in a range of $14.1 billion to $14.2 billion, up 10.5% to 11% versus the prior year, and up 7.5% to 8% organically. Adjusted operating profit is expected to be in a range of $2.16 billion to $2.18 billion, up $240 million to $260 million at actual currency, and up $170 million to $190 million at constant currency.

We're improving adjusted EPS by $0.10 of the midpoint versus the prior outlook, and now expect it to be in a range of $2.89 to $2.93, a 15% to 16% increase versus the prior year. Lastly, we are improving our free cash flow outlook to a range of $1.45 billion to $1.5 billion, with about 120% conversion of GAAP net income.

With that, I'll turn it over to Rahul to walk through our Q2 results and 2021 outlook in more detail.

Rahul Ghai

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

Thank you, Judy, and good morning, everyone. Starting with second quarter results on slide 5. Net sales grew 22.2% to $3.7 billion, as the strong growth momentum continued in New Equipment, and Service grew for the second consecutive quarter. Adjusted operating profit was up approximately 25% or $115 million and up $80 million at constant currency, primarily from the benefit of higher volume in both segments.

Favorable service pricing and productivity initiatives in both New Equipment and Service helped offset the headwinds from commodity inflation and the absence of temporary cost actions taken last year to absorb the impact from COVID-19. We maintained the focus on cost containment while continuing to invest in the business, and adjusted SG&A was down 60 basis points as a percentage of sales despite the step-up in public company expenses.

R&D spend and other strategic investments were up approximately $8 million versus prior year and were about flat as a percentage of sales. This strong focus on execution resulted in 40 basis points of margin expansion in the quarter and 1 full point of margin expansion at constant segment mix. Second quarter adjusted EPS was up 41% or $0.23, driven primarily from $0.18 of operating profit growth and $0.06 from a lower adjusted tax rate.

Moving to slide 6. New Equipment orders were up 23.9% at constant currency, with growth in all regions. Orders momentum continued in the Americas and EMEA, up approximately 47% and 19%, respectively, as the markets recovered and the investments made by Otis continued to deliver. Orders in Asia were up approximately 17% and were up for the fifth consecutive quarter, including strength in China where the orders were up mid-teens with record bookings during the quarter.

Pricing was down 60 basis points, similar to the first quarter. Organic sales were up 25.4%, with Americas and EMEA up mid-30s, driven by strong backlog execution as the business continues to progress towards pre-COVID levels. Asia was up mid-teens, driven by China where organic sales were up double-digits. Despite strong sales, there was broad-based growth in backlog that was up 10% and up 5% at constant currency, with backlog margin down about 0.5 point versus prior year, including any adverse product mix impact.

New Equipment adjusted operating profit was up $64 million, primarily driven by higher volume, the strong year-over-year improvement in installation execution and continued focus on material productivity helped offset the unfavorable impact from price mix and commodity inflation. Adjusted operating profit margin expanded 2 percentage points.

Service segment results on slide 7. Year-over-year growth in the number of units under maintenance contracts accelerated to 3%, reflecting strong global improvement in retention, recapture, and conversion rates versus prior

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year. Number of units increased in all regions, and China was up mid-teens after a high-single digit growth in 2020.

Modernization orders were strong in the quarter, up 16.8% at constant currency as North America and Europe grew double digits, a sharp rebound after a decline in 2020. Modernization backlog was up 4% at constant currency, providing a foundation for sales growth in the subsequent quarters.

Service organic sales were up 7.8% with growth in all lines of business. Growth accelerated in maintenance and repair with 7.5% from a strong recovery in repair with the contractual maintenance remaining resilient. Modernization sales were up 9.3% from continued momentum in Asia Pacific and China and pickup of activity in EMEA.

Adjusted operating profit grew $55 million from higher volume and improved pricing, including favorability from the absence of price concessions made last year. Translational FX benefit of $24 million was more than offset by incremental public company expenses and the snapback of COVID-related cost containment actions taken in the prior year. Adjusted operating profit margin expanded for the sixth consecutive quarter and was up 10 basis points.

Overall, the first half results reflect solid performance across all metrics, with 1.5 percentage points of New Equipment share gain, 13% organic sales growth and close to $200 million of adjusted operating profit growth.

First half New Equipment and Service organic sales were up 25.3% and 4.5%, respectively, with margin expansion in both segments. Free cash flow generation was robust at $1 billion, enabling us to raise dividends and complete a debt repayment and previously announced $500 million of share buyback.

As we look forward to the second half of 2021, on slide 8, we feel confident about growth across all key metrics given higher backlog, growth momentum in all lines of business, and our focus on operational excellence.

This, combined with strengthening demand in our end markets and strong first-half results, gives us confidence to raise organic sales outlook to be up 7.5% to 8% for the year, up 275 basis points versus prior outlook. We now expect adjusted operating profit to grow $240 million to $260 million, up from $55 million in the prior outlook at the midpoint; with sales growth, operating profit growth, and margin expansion in both segments.

Adjusted EPS is expected in a range of $2.89 to $2.93, $0.10 higher than prior outlook and up 15% versus the prior year at the midpoint. The year-over-year EPS increase is driven by strong operating profit growth; 140-basis-point reduction in that adjusted tax rate, that is now expected to be 29% for the year from 29.5% in the prior outlook; and a reduced share count.

Following the strong cash generation in the first half from net income growth and close to $300 million of reduction in working capital from the end of the year, we now expect free cash flow for the year to be in a range of $1.45 billion to $1.5 billion. This is $75 million higher than prior outlook at the midpoint from improved net income and better working capital performance.

Given the improved free cash flow outlook and the success in repatriation of foreign cash, we are increasing the share buyback target for 2021 to $750 million. In addition, we will continue our bolt-on M&A activities and are always open to other opportunistic investments that can create value for our customers and shareholders.

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Taking a further look at the organic sales outlook on slide 9. The New Equipment business is projected to be up 12% to 13% from 7.5% to 8.5% previously, driven by accelerated backlog conversion and continued recovery in the construction activity in several countries. This 450-basis-point increase from prior outlook includes improved expectations in all regions.

EMEA is now expected to be up high-single digits, and we expect low-teens growth in the Americas and Asia driven by China. We are also improving our Service outlook by 125 basis points at the midpoint, now expected to be up 4% to 4.5%.

This reflects improvement in maintenance and repair that is now expected to be up 3.5% to 4.5% from maintenance portfolio growth and stronger discretionary repair demand. Modernization business is now expected to be up mid-single digits, driven by higher Q2 ending backlog.

Overall, the organic sales outlook of 7.5% to 8% reflects growth across all regions and all lines of business.

Switching to operating profit on slide 10. We now expect operating profit to be up $240 million to $260 million versus prior year, including FX tailwind of approximately $70 million from strengthening of the renminbi and other currencies against the US dollar. At constant currency, operating profit is expected to be up $170 million to $190 million.

Total company margin is projected to improve by 30 basis points. This outlook reflects the benefits of higher volume, service, material, and installation productivity initiatives and favorable Service pricing. It is partially offset by unfavorable New Equipment price mix, headwinds from incremental stand-alone expenses, and higher commodity prices.

The commodity headwind for the year is now expected to be $70 million to $80 million for the year, approximately $35 million to $40 million higher than what we communicated in April, as metal prices have stayed at an elevated level. Despite this incremental headwind, we are improving our earnings outlook for the business by approximately $55 million, with improvement in both segments.

And to help alleviate the incremental commodity cost impact this year and in 2022, we are broadening the price increases announced last quarter to include additional markets. This outlook is not only a sharp turnaround from 2020, but also puts us more than $1 billion ahead of 2019 reported revenue, with 100 basis points of margin expansion.

2021 revenue, earnings, and margins in both New Equipment and Service segments are expected to be higher than 2019. This improvement reflects our confidence and long-term strategy, ability to execute, and the benefits of a solid end market recovery.

And with that, may I request Angie to please open the line for questions.

Michael Rednor

Senior Director-Investor Relations, Otis Worldwide Corp.

Angie, can we take the first question?

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QUESTION AND ANSWER SECTION

Operator: Jeff, your line is open. Please state your question.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Hi. It's Jeff Sprague of Vertical Research.

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

A

Hi, Jeff.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

I have two questions. Good morning, everyone. Just first, on the revenue outlook Judy or Rahul, you did mention accelerated backlog conversion. I'm just wondering how that's playing into the top line in so much as the guide would suggest revenues, in absolute terms, step down a bit in the back-half relative to this Q2 level? So, could you give us a little color on that, just kind of what's going on with backlog and what you're thinking about conversion?

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

A

Yeah, Jeff, good morning. Listen, we're really pleased with the backlog conversion we've seen through the first half of the year. It was obviously slower through 2020, and the compares certainly for this quarter were favorable and our team performed very well.

The compares do get a bit tougher but we – with our orders up so significantly, 23.9%, and our backlog is up 5%, so we're not burning – we didn't pull ahead and not replenish; we're actually delivering more for our customers and driving more backlog there. But the compares do get tougher. If you recall, second half of last year, both Americas and EMEA grew stronger, especially in the fourth quarter. So, we think we're going to still see about the same momentum but the compares do get bit tougher.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Sure. And then, as you noted in your pitch, up and down the line, things are just kind of better than you were expecting and better than, certainly, the initial Analyst Day early last year. I know you've been giving some thoughts on updated outlook and longer-range plans, I wonder if you could give us a sneak peek on what you're thinking about in terms of timing or magnitude in these particular metrics, particularly around margins and growth.

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

A

Yeah. So, Jeff, we've been – and when we did Investor Day in February of 2020, standing up as a new independent company, and then faced – we had already been experiencing the early days of COVID in China, we weren't quite sure what the mid-term outlook that we shared, where that would come out.

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Again, strong performance through 2020 and 2021. And if you really look at EPS itself, almost up 13% in 2020 and our new guide at the midpoint really has it up 15% this year, we had been talking about high-single digits at the mid-term outlook. So, we're going to revisit that as we go into the second half of this year and we'll share more with you, we believe, early in 2022 with probably a revised mid-term outlook on all the metrics.

Again, the end markets are far more positive and if you have a chance and look at slide 19 in the back-up, you'll see for adjusted operating profit for organic revenue, We did a compare that takes us to 2019, 2020, and 2021; and the 2021 outlook beats every metric fairly significantly, even from 2019. So, Rahul and I have some work to do there and we will get back to you in early 2022.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great, thanks a lot. Appreciate it.

Operator: Your next question comes from the line of Nick Housden with RBC Capital Markets.

Nick Housden
Analyst, RBC Capital Markets

Q

Yes. Hi, everyone. Thank you for taking my questions. My first one is just looking at the guidance upgrades and my sense is that the underlying assumptions for H2 haven't really changed. The raise is more just a reflection of the strong Q2 results. Is that a fair assessment of the situation?

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

A

I think that's fair, Nick. Good morning first, by the way. No, that's a fair assessment. I think as you look at – and Judy kind alluded to that a little bit in her response to Jeff. I mean, if you look at between first half and second half, they're definitely more difficult to compare, both on New Equipment and on Service. We were down about 10% in the first half of last year on New Equipment, up a couple of points in the second half on New Equipment in 2020. So, the compares get tougher.

Service Q2 last year was a weaker – weakest quarter, I would say, and then Q3 and Q4 were down but not as down as Q2. So, definitely, tougher compares getting into the second half. So, that – as we look at first half and second half compares for 2021, New Equipment growth definitely slows down, but Service is about flat in both – up 4%, 4.5% both first half and second half. So, that growth looks consistent.

And then, if you look at the – on the earnings side, obviously, second half reflects the change in volume growth assumptions but also incremental commodity headwinds that we are seeing in the business, which is going to be a little bit more back-half loaded. So, you're seeing that and – but, I mean, our productivity initiatives continue to deliver. We're seeing good improvement in our installation execution out in the field. So, that is covering a lot of issues that we are – that we're dealing especially on the commodity side.

And if you look at first half and second half; I mean, second half, our earnings continue to grow, our margins continue to expand in both segments, and we had a decent drop-through coming on the volume growth that we're seeing. So, we're seeing about a 10 basis points expansion on the New Equipment margin with second half, and 90 basis points overall for the year. And on Service, we're seeing about a 40-basis-point, 50-basis-point

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expansion in the second half; and about 40 basis points for the full year. So, we think it's a solid second half, recognizing a slightly different environment and a bit more difficult compare.

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

A

Yeah, Nick. It's Judy. Let me just to add on to Rahul. We also have some one-off support that we're trying to offset, including some government help that helped us in 2020 that's going to come through in the second half of the year. But we have seen, again, for the second quarter with repair and modernization, revenues up and orders up in both that gives us comfort on the Service side and a 40-basis-point margin expansion full year for Service.

We will – when you think – when you look at the new guide, even with that second half, as we've contexted it, even with all of our abilities to offset the now $70 million to $80 million of raw material, the commodity headwinds, I mean, there's really a good outcome here. Our profit's going to be up $240 million; our EPS is going to be up 15%, even accounting for all that and a higher stand-alone cost and an extra quarter of interest expense; and that's coming off a strong 2020 where we grew operating profit and grew EPS as well. So, for us, it's growth on growth which, we believe, all of our colleagues listening understand that is our mantra, that is our strategy.

Nick Housden
Analyst, RBC Capital Markets

Q

Thanks. And then, if I can just add on to that, I mean, listening both to your results today and to your competitors last week, I mean, it almost feels like you've been taken by surprise by the strength that we've seen in Q2. I'm just wondering if, when you look at this strength, are there any areas where you feel like it's unsustainable either in particular business lines or particular geographies or anything that should give us a reason to think that there's maybe a bit more risk in H2 and into 2022?

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

A

Yeah, not really, Nick. I mean, the Americas got off to a better start than we expected. The market's up mid-single digits. EMEA was stable in 2020 and we expect low to mid-single digit growth in 2021 and we're seeing that. We still are watching Asia-Pacific ex-China because there are still – obviously, India's coming back but Singapore is in lockdown and several other Southeast Asia countries are in lockdown. So, we're watching that with caution and thinking about our colleagues and customers there.

But really, no surprises. The second half on Service, EMEA and Americas are going to continue on a low-single digit; and the New Equipment market is going to continue to feed our Service market, having the portfolio where we did for the first time at 3% and the backlog up 5% on New Equipment is really what gives us the confidence to drive the sales and then the orders execution, we haven't seen real drastic changes in the end markets that would give us pause.

Nick Housden
Analyst, RBC Capital Markets

Q

Okay. Great. Thanks very much, guys.

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

A

Thank you.

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

A

Thank you.

Operator: Your next question comes from the line of John Walsh with Credit Suisse.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning.

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

A

Morning, John.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Maybe a question, as it relates to price cost. Appreciate all the color earlier around that equation, wanted to dive a little bit into China. One of the things that we had picked up is it seems like there are several OEMs trying to get a price in China as we look forward in the back half of the year. Is that something you're seeing? Do you have any plans, any color you can kind of give there on the pricing dynamic on the ground in China?

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

A

Yeah. Sure, John. As Rahul mentioned, one of the three strategies we have to offset the commodity headwinds we're facing, is a more broad-based price increase. We started this last quarter very focused in a few countries and, now, it'll be more broad-based and go across all of our regions. We are – we always look at this in terms of what the market can bear and how the competitors respond. In China, the top 10 OEMs have 90% of the market segment, so we heard the same thing you did last week about people raising prices.

We are doing similar but, obviously, we'll tailor it to the segments in China where we think we can get price and not give up share as well. Our – I'm really pleased China results so far, as we came through the quarter, record orders in the mid-teens, so very pleased with that double-digit sales and the team grew our portfolio mid-teens. So, we gained share. We think we grew faster than the market. And even if China get – becomes more stable versus the high-single digit growth we saw in the segment in the first half, it'll still be a growth segment not on – the segment will be a growth for the year and it'll certainly be growth for Otis.

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

A

And just to add to that, John. I mean, part of the reason why we feel okay about our situation in China is, if you look at the floors' rates under construction, that's up more than 10% over last year and 13% over 2019; and the real estate investment in China is up 15%. So, there's a lot of activity happening in China. We feel that the overall market growth in China has gone up from kind of mid-single digits when we started the year, to maybe mid-single digits plus, and now we think it's high-single digits. So, their market's definitely growing and that gives us incremental ability to pass on a little bit of price in China.

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John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Thank you for that. And then, maybe just a question around digital. I think a lot of the – well, I'll just ask the question here, if you're seeing customers really increase their take-up of kind of paid digital services or if this is really still an opportunity more around kind of the cost-driven payback of upgrading to a digital service? Just curious what you're seeing there from kind of customers' acceptance and willingness to actually take these services? Thank you.

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

A

Yeah. So, John, our strategy was to control and drive productivity first with giving customers value, whereby we control the deployment of the Otis ONE units so that we had and were able to take advantage of route density, as well as other productivity measures for us. Obviously, our customers get visibility into this. We started seeing uptake on our Otis ONE subscription services, but it's early days.

But we believe in it and that's why, as we rolled out our Gen3 and Gen360, they are Otis ONE digitally-enabled. So the IoT is built-in, we're now shipping units with Otis ONE already built-in so that we have the foundation; we have the ability to do over-the-air updates to add features, to add value. Still early days but we have seen the customer uptick not to where it's material yet in the revenue.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thank you.

Operator: Your next question comes from the line of Steve Tusa with JPMorgan.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hey, guys. Good morning.

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

A

Hi, Steve.

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

A

Good morning, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Just kind of a question on the margins again. The – what was – what do you expect kind of price to be for this year and kind of that lever to offset the commodity costs? And then, when you look out to the next couple of years, is there any kind of bump in the road when it comes to margins and, ultimately, you guys are performing well here but is there a potential for kind of a higher entitlement back to where you were before, way back when in the good old days?

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

Well, Steve, let me start and then I'll let Rahul add to it but – so with these price increases, the order-to-revenue cycle is variable throughout the globe, and some countries drive an earlier benefit from the price increases than others. So, the price increases that we started last quarter will start flowing through later this year. The price increases we started in July, we'll see some of that at the end of this year. But the majority of that, we put in place to, again, have protection through first half and, more importantly, second half of 2022.

So, it's been targeted but the real actions to drive the offset beyond price that we're going to see quickly are the productivity we've gotten in installation which, as any of you just follow us know, we've had all these Service productivity initiatives, we've invested in technology there. There is ripe opportunity for us to continue to yield installation productivity; and then, our material productivity has not stopped in the factories. And we were yielding 3% every quarter that we anticipate material productivity to continue to help us offset this and it's included in our outlook, but I'll let Rahul add there and see what he wants to say about returning to the days of old.

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

You know what, listen, it's early days, Steve, right. I mean, again, I think Judy alluded to it on her response to an earlier question. Clearly, we are very, very pleased with the progress we made over the last couple of years since Investor Day, between what we were able to do in 2020 and now 2021. I mean, obviously, between the two years, we have more than 100 basis points of margin expansion.

So, it is very, very good progress, a good return to growth, and the numbers are above 2019 levels. And if you look at the absolute a profit dollars, I feel that is – the margins may not be, but I think we feel definitely – feel really good about delivering the absolute profit dollars and maybe, at that point, I don't know what the peak was but our revenue is probably $3 billion to 4 billion higher than where it was back in 2010, 2011.

And even if the margins are lower, I think in absolute profit dollars, we may be kind of getting there. I don't know, I haven't gone back and checked the AFX numbers for 2010, 2011 but it feels like – and that's an important metric for us. But, listen, we'll continue to work it. We are clearly doing everything that we should be doing in the business, and we feel we've got good traction. And as Judy said earlier, we'll come back and kind of update our medium-term guidance early next year.

[indiscernible] (00:40:00)

C. Stephen Tusa
Analyst, JPMorgan Securities LLC
Q

It was 20%, I can send you the number just in case you don't have it there. And then, just one last question. On the 3% maintenance – units under maintenance number, what was the biggest lever on that? You guys had some good, obviously, new unit deliveries. Could you just give us a bit of an update on kind of attrition and recapture?

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

The numbers continue to improve in all metrics, Steve. Conversion rates are better, including conversion rates in China. I think they were – they maintained their margin towards our 60% target that we've set for ourselves, and they have been – and again, as we've said before, we expect a meaningful improvement this year...

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

A

In China.

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

A

...in China on the conversion rates, and we are getting there. The recapture rates were better as well in China where we have the biggest opportunity, and the retention rates continue to improve as well.

So, I think we are making good improvements across all three metrics and, like we always do, we'll update you guys annually on where we end for the year. But it was an improvement across all key metrics for Otis overall. And, obviously, in China, you're seeing some really good traction on the portfolio growth. And the units were up in all regions. So, we're seeing some good traction overall in the Service portfolio.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Right, and that...

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

A

Steve, our retention rate is still at 94% [ph] at around (00:41:23) – we can't go up and we certainly, with those actions, wouldn't go down.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

And that 3% unit growth can translate into something a bit higher on the revenue side, right? That's my last question.

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

A

Yeah. Yeah, absolutely. And if you look at the Service pricing overall, Service pricing has continued to track well. We've – and we've – part of that, we reflected that in our guidance. Also, Service pricing continues to track well. The concessions have come down to de minimis levels overall.

So – and this high inflationary environment that we're seeing should help us on Service pricing because most of our contracts in Europe and Americas have price escalators kind of built-in that are largely tied to labor inflation. And, historically, we've always had that lever but given low inflationary environment in the macro market, the prices don't always stick. And now, with this inflationary environment, we should have a greater ability to stick those prices, so that should help next year.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Great. Thanks a lot, guys. Appreciate it.

Operator: Your next question comes from the line of Cal van Rumohr (sic) [Cai von Rumohr] with Cowen.

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Cai von Rumohr
Analyst, Cowen & Co. LLC

Q

Yes. Thanks so much. To follow-up on kind of Steve's question, maybe you'd give us a little bit more color on the 3% Service growth? I mean, you mentioned China mid-teens but where was it elsewhere and give us maybe a little more color also in terms of the conversion and the recapture rates?

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

A

So, it was a broad-based growth, Cai. I mean, Asia-Pacific, that's our next biggest opportunity in terms of portfolio growth because those – that has some developing markets. So, that clearly continues to add to our portfolio account as well. So Asia-Pacific, I would say, would be number two. And then, Americas and Europe are obviously more mature markets so the portfolio growth is lower compared to the other two regions. But, again, all regions grew their portfolio, Cai. So that is obviously very, very good; and you see the overall growth accelerated.

And, as I said in response to an earlier question, I think that all key metrics improved. So, we're seeing good improvement. I mean, our recapture rates are better; conversion rates are – continue to edge up. And obviously, China is the biggest opportunity; and there, we made a meaningful step in the right direction. And retention rates have – again, I'm repeating what – myself, but it just continues to improve. I mean, every little bit helps because we've got – obviously, on 2.1 million units, every 10 basis points helps and that was up year-over-year. The retention was up year-over-year.

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

A

Cai, the other element that most people – it's a little bit of a nuance, but I want to make sure everyone understands is, as we do modernizations a lot of those are off portfolio that we then bring back, do the modernization, and it becomes part of our portfolio going forward. Modernization orders were up double-digit in the Americas, EMEA, and China that led us to this kind of 17% across the board, so the mod business is coming back nicely, especially post-pandemic.

Some of it's pent-up demand, but a lot of it is just elevators are now 1 year, 1.5 year older, and so there's almost 6 million elevators over – out there that are over 20 years old. They're not all in our Service portfolio, but modernization gives us an opportunity not just to recapture them but to recapture them, do a modernization, and then start the service cycle all and put them in our portfolio.

Cai von Rumohr
Analyst, Cowen & Co. LLC

Q

Great. Thanks. And then, in terms of rollout of IoT and connectivity, I think your target was 100,000 units. Can you maybe update us there?

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

A

Yeah. We're on track for the year. We'll finish with another at least 100,000 units this year. We are shipping from the factories, as well as we've now started shipping. Obviously, we have new orders on Gen3, which is our IoT-enabled platform everywhere; but EMEA, which has the Gen360 rolling out, which is also IoT-enabled. So, we're going all in.

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We believe it make sense for us as we're going through the change management with our field professionals. They have been embracing Otis ONE, and I've heard some personal stories in Chicago – in the Chicago suburbs and other locations where it's just – it's amazing how this is driving less entrapments, as well as customer satisfaction because we are actually proactively repairing parts of the elevator before the customer even has a shutdown.

So it's being viewed well internally, which is important, to get that ground swell. Our field professionals really are appreciating it. We've gotten the installation time down to very small minutes, in terms of installing a unit. And it – this is our future, the connected elevator is here and Otis ONE helps us start that and becomes that foundational platform.

Cai von Rumohr
Analyst, Cowen & Co. LLC

Q

Terrific. Last one. You added to your sales force last year and you added agents in China. Can you maybe update us in terms of what you're doing there?

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

A

Sure. In this quarter, we added another 150 net, so we're up to 2,150 agents. So that's – we continue to tune it, so you won't see the same acceleration but we're also appropriately doing some assessments on who should be in, who should be out, so that we have the yield. I think what we're seeing for the second quarter in a row, is we gained share in the Tier 1 and Tier 2 cities, which is where we were not performing as well as we needed to, and we're gaining share with the key accounts in China.

So, the Asian distributor network is working for us and I'll just – Rahul spoke in his remarks about SG&A and us driving that down 60 basis points this quarter. Our SG&A and the dollar amount actually grew because we are investing in the S part of it. We're continuing to add sales resources in focused markets where we're focusing on key segments and underserved markets in specific countries throughout the globe; and our team's executing very well on that while we're trying to obviously drive the G&A piece down on increasing revenue. So we are committed to sales coverage, whether that's through direct sales, people in certain parts of the world, or our agents and distributors.

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

A

We have added about 100...

Cai von Rumohr
Analyst, Cowen & Co. LLC

Q

Thank you very much.

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

A

Just to add little bit more color, Cai, we've added about 100 salespeople this year. So, between last year and to the first half, our salesforce is up about 6%. So, that is – that's a step in the right direction, and the digital marketing efforts are also yielding a lot of results. I mean, our digital sales, our bookings are up to x where we were in the first half last years. So it's just not feet on the ground, but also the digital strategy that's paying off.

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Cai von Rumohr
Analyst, Cowen & Co. LLC

Q

Terrific. Thank you very much.

Operator: Your next question comes from the line of Julian Mitchell with Barclays.

Julian Mitchell
Analyst, Barclays Equity Research

Q

Hi. Good morning.

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

A

Morning, Julian.

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

A

Hi, Julian.

Julian Mitchell
Analyst, Barclays Equity Research

Q

Good morning. Maybe just wanted to clarify on the pricing commentary. Because you talked about prices going up more recently, prices going up into next year as well, but there was a comment at the beginning of the prepared remarks about the pricing down 60 bps. So, maybe I had misheard that, but just wanted to sort of try and square, with the down 60 bps you're sort of lagging backlog number net or something, and then when we're looking forwards to the gross and net price that starts to swing more positively?

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

A

No, Julian, you heard it exactly right. I think both the statements are accurate. I mean, pricing was down in the quarter, similar to the levels that we saw in Q1. The price increases that we put in place in Q2 that we spoke about earlier, they were in – A, they were in targeted countries. I mean, we were very, very careful because, again, it was early in the year. We were not sure how the markets were recovering, so we were very targeted in those price increases. Obviously, that is still going through the quotes to the order cycle.

So, hopefully, you'll see the benefit of that in the second half of this year. We do expect pricing headwinds, in terms of absolute dollar terms, to be lower in the second half than we had in the first half. So, that should start to help. And then, we've put in prices – incremental price increases in additional markets. Across the world, this is a far more broader price increase and this is because the markets are recovering better than what we thought. Americas – I think Judy said it earlier, Americas is now expected to be up maybe mid to high-single digits versus up slightly at the beginning of the year. China is going to be up more high versus mid.

So, markets are trending in the right direction and that gives us confidence, okay, market has the ability to absorb these price increases. So, we are – there's a much broader price increase and that should show up into our numbers and more in 2022, and maybe some in the first half but maybe more in the second half in terms of absolute dollar benefit. So, I think both those statements are absolutely accurate because this 60 basis points of price decline that we saw in the quarter was more in response to the quotes that we showed last year.

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

And Julian, of our $17 billion of RPO, 89% of that we recognized as sales in the following 24 months, which gives us time for productivity initiatives, gives us time for learning curves on all of that backlog; and as Rahul said, that backlog margin. And when you look at the performance this quarter, to be up 2 points in New Equipment from that which we bid within the – 6 to 20 months ago, I think shows that we know how to drive those learning curves and the productivity.

Julian Mitchell
Analyst, Barclays Equity Research
Q

Very helpful, thank you. And just my second question around capital deployment, as I don't think that's come up yet in the Q&A. Noticed the decent share buyback increase. Clearly, they're very sort of high and stable cash flow levels, meaning you have a lot of scope for capital deployment beyond this year. So, just wondered how you're seeing the M&A environment right now. There is an opportunity to go out there and buy up a lot of service providers locally in different regions, for example. Just wondered how appealing doing that systematically on a large scale would be?

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

Yeah, we ended the quarter with $1.9 billion of cash on the balance sheet and we clearly don't require that much cash to operate this business. Second quarter of negative net working capital. So, everyone was very – remains very focused on that. We've continued our small service company acquisitions. We've targeted – and we shared this in Investor Day – $50 million to $70 million a year in doing that, and the challenges is their readiness.

We've got a good book of potential targets that we continue to look at, but the owners have to be willing to sell, and then it has to meet our model in terms of being accretive and as well as being on the right place for us to add to our routes and to our locations from a density standpoint. So, we do many of those are private, transactions with private companies so you don't hear about all of them but it's robust and it's continuing.

We remain open to all opportunities from an M&A perspective, and we don't know when generational opportunities will come around, but we remain open and evaluate all opportunities. A year and a half ago, we needed to repay debt, we needed to start our dividend, we had no cash – no stock buybacks, we've repaid the debt we thought was at the appropriate level now so that our net debt to EBITDA is about 1.7x kind of level, which we think is very healthy with the debt we're holding.

We increased our dividend last quarter; and we've increased share buybacks, we weren't originally planning to do any this year. We announced $300 million in the first quarter or at the beginning of the year, $500 million last quarter, and now we're upping it to $750 million. So, we will continue to drive shareholder value and remain open to M&A opportunities as they arise.

Julian Mitchell
Analyst, Barclays Equity Research
Q

Fantastic. Thanks very much.

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

You bet. Thanks, Julian.

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

A

Thanks, Julian.

Operator: [Operator Instructions] Your next question comes from the line of Nigel Coe with Wolfe Research.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks. Good morning. Thanks for the question. We've covered a lot of ground already but I want to go back to the 3% unit growth in maintenance units. That's a pretty big number. Do you think you can maintain that level of growth in units? And what I'm trying to [ph] draw back (00:54:37) here is, if you do volume growth at that level with price, maybe an acquisition or two, and then maybe if digital starts hitting and getting traction, then we could be looking at well north of 5% Service growth? I mean, I'm just wondering if that is sort of how you view the board as well? But the main question is, do you think 3% can be sustained?

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

A

Yeah, Nigel, I think you've got a fairly accurate assessment, as usual, about our business. We do think it's sustainable now that we've achieved it. We set it as an internal target as we started the year. We've never hit 3% in the last decade. And so, to us, this was important because, as you know, our service drives 80% of our profits, and then this has that knock-on effect, obviously, of the 5% you were talking about.

So, we set the target ourselves. We knew we needed to grow our portfolio in China, where the Service market is growing faster than anywhere else; as well as in the emerging markets, including India, Southeast Asia, and other emerging markets. Our team has taken that on-board and this quarter was the first time we hit 3%. Last year, we were at 2%. I believe, in 2019, we rounded to 1%.

So, we have a strategy in place to execute to do this and a lot of it is basic block and tackling, perform, drive the conversions, drive the retention, stop the cancellations, delight the customer, and then add that digital layer – that foundation layer of IoT that gives us more stickiness. And it's not just IoT, it's our eView, it's any of our – any time we're connected to the customer, all of our retention rate goes up, our conversion rates go up.

And so, whether it's eCall or compass dispatch system, everything we're doing now with our – I'm just so excited about Gen3 and Gen360 and having now that architecture out there that will give us that foundation to continue to grow, and it's all about growing the service portfolio. So, I think you got it accurate and I think it's sustainable.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Thanks, Judy. That's great. And then, on the buyback uplift, I know that, Rahul, that the cash flow around the organization hasn't been – wasn't optimized; [indiscernible] (00:56:53) at the time of spin. Are we in a position where we've greased the wheels and we now have more fluid cash flow globally and just any kind of thoughts on tax optimization strategies?

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

A

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Tax – Nigel, we keep making progress. I mean, we obviously lowered our tax rate to 29% from 29.5% previously, 30.4% last year. So, 140-basis-point reduction in the year. So, I think it's moving in the right direction – our long-term guide or medium-term guidance, still in the 25% to 28%, so I think we'll continue to move towards that numbers. So, obviously, there's incremental improvements that you'll seen in 2022, and then 2023.

And then, on repatriation, listen, this – the incremental $250 million that we're able to do speaks well to the work that our teams are doing just to continue to look at different strategies to bring cash back to the US where we can put it to work. So, not to rehash the stuff that Judy just mentioned, but it is – it clearly shows that we're doing our job but – and that is something we'll need to continue working on. I mean, it's not a one and done thing.

This is something that we need to keep pushing because we're going to keep building our cash offshore and we'll have keep thinking of how we'll bring it back to the US. So, that has to be an ongoing activity, but really good progress. I mean, our repatriation is probably going to be maybe 1.5x to 2x what we did last year. So, clearly, a lot better this year and then we'll need to think about what we can do next year. So, that's an ongoing activity for us.

Nigel Coe
Analyst, Wolfe Research LLC

Q

All right. Thank you very much.

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

A

Thanks, Nigel.

Operator: At this time, there are no further questions. I would like to turn the floor back to Ms. Marks for any additional or closing remarks.

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

Thanks, Angie. This solid first half of 2021 demonstrates the resiliency of our business, the strength of our strategy, and our ability to execute and innovate. I'm confident that this positive momentum, the dedication of our colleagues, and the pace of recovery in our end markets positions us well to deliver on the improved 2021 outlook. Looking forward to the second half of the year, we'll remain focused on driving value for our customers, colleagues, communities, and shareholders.

Thank you for joining us today and please stay safe and well.

Operator: This concludes today's conference call. You may now disconnect your lines at this time.

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