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Otis Worldwide Corp. (OTIS)

Q2 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

I would 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, Chris, and good morning, everyone. Welcome to Otis's second quarter 2020 earnings conference call. On the call with me today are Judy Marks, President and Chief Executive Officer; and Rahul Ghai, Executive Vice President and Chief Financial Officer. Please note except or otherwise noted, the company will speak to results from continuing operations, excluding restructuring and significant non-recurring items. The company will also refer to adjusted results where adjustments were made as 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 our Form 10 and quarterly reports on Form 10-Q provide details on important factors that could cause actual results to differ materially.

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

Judith F. Marks

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

Thank you, Stacy, and good morning, everyone. We're glad that you could join us today and hope that everyone listening is safe and well. I'm very pleased with our results and grateful for the dedication of our colleagues, who provided essential services and supported our customers in efforts to safely reopen job sites and buildings during these unprecedented times. To briefly update you on the status of operations in this environment, today, all Otis factories are operating and approximately 90% of New Equipment job sites are opened, up from a low point of about 65%. In the quarter, Otis field professionals provided essential services and our maintenance business remained resilient. However, the shutdown of buildings put understandable pressures on our repair and modernization business. By June, we saw encouraging signs of improvement in many regions. In the New Equipment business, we experienced substantial recovery in China during the second quarter while North America, EMEA, and Asia Pacific continued to experience jobsite closures in certain areas. Our management team has done an excellent job to proactively contain costs and mitigate the impact from COVID-19 that was reflected in our results reported this morning especially encouraging in our Service business.

In terms of liquidity, we ended Q2 with $1.9 billion of cash on hand and have a $1.5 billion undrawn revolving credit facility, a strong position for us to run the business. This environment has not slowed our progress in executing on our strategies. We continue to introduce new and innovative products with our touchless elevator technologies, traffic flow solutions, purification products or remote monitoring and predictive maintenance services, we are partnering in bringing solutions to our customers to promote and support the health and safety of their tenants and passengers. We continue to expand our product offerings launching the Gen2 Prime in India, a low-rise entry-level elevator. This product brings a combination of safety, performance, themed aesthetics, and price competitiveness to our India low-rise market with applicability to other developing markets. We continue to build momentum on the deployment of IoT and we recently launched a new release that added several new features for our customers and to drive productivity in our organization. This new release also improves the scalability of our solution. We have a clear roadmap to continue to enhance the capability of our IoT solutions over the next several months.

Despite the challenges introduced by the pandemic, we continue to deploy units in US, Europe and China in the first half and expect the pace of IoT deployment to increase substantially in the second half. And we've driven both service and material productivity through our continued IoT technology, our suite of mobility tools via iPhone apps for our field professionals and our global supply chain activities this quarter. These are just a handful of examples that led to 90 basis points of New Equipment share gain during the first half. This progress shows the strength of our strategy.

As leaders here at Otis, we're proud of our company's long commitment to diversity and inclusion, yet we also know there's more to be done if we're to become the company we want to be, an equal opportunity employer of choice for people of all cultures, genders, races and generations. To ensure we live up to these aspirations, our leadership team and I launched our commitment to change which is a framework to help us identify and prioritize the actions we need to take. We continue to demonstrate our commitment as Otis joined the Paradigm for Parity coalition and committed to closing our global leadership gender gap by 2030. People are at the heart of everything we do at Otis and I'm proud of these important steps. Otis will lead our industry for inclusion and diversity.

Turning to slide 4; Q2 results and 2020 outlook. New Equipment orders were down 6.8% at constant currency with double digit declines in the Americas and EMEA partially offset by growth in Asia as China recovers from COVID-19. China orders were up high-single digits including several infrastructure awards. On a rolling 12 months, total Otis orders were flat. New Equipment backlog was up 2% versus the prior year. In the second quarter, organic sales were down 6.5%, driven by double digit decline in the New Equipment segment and low-single digit decline in the Service segment. Adjusted operating profit was down $24 million at constant currency and margin expanded 30 basis points, driven by continued expansion in the Service segment and the swift cost containment actions we implemented. Free cash flow was robust at $628 million with 280% conversion of net income, reflecting strong working capital performance in the quarter. These swift cost actions and our organization's commitment to serving customers allowed us to mitigate the bottom line impact from a year-over-year decline in sales and I'm pleased with the second quarter and first half performance despite the difficult environment we're operating in globally.

We are encouraged by the recovery we've experienced in China and are revising our 2020 outlook to reflect the solid first half performance and anticipated pace of recovery for our business in the second half across the world. We are increasing the organic sales range; now expect to be down 2% to 4%. Adjusted operating profit is now expected in the range of flat to down $50 million at constant currency, a $75 million improvement versus the prior outlook at the midpoint primarily from higher volume expectations. We now expect adjusted diluted earnings per share in a range of $2.20 to $2.30, up $0.20 at the midpoint versus prior expectations. This reflects our improved operating profit outlook, lower tax rate and lower net interest costs.

Lastly, we expect free cash flow to be robust between $1.0 billion and $1.1 billion with full year free cash flow conversion levels between 130% and 140% of GAAP net income.

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

Rahul Ghai

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

Thank you, Judy, and good morning, everyone. Starting with second quarter results on slide 5. Net sales were $3 billion down 9.6% with a 6.5% decline in organic sales and the rest from foreign exchange and net divestitures in 2019. As we anticipated and communicated during the first quarter earnings call, both the New Equipment and Service segments declined organically in the second quarter primarily from the impact of COVID-19. Adjusted operating profit in the quarter was down approximately 8% or $39 million and down $24 million at constant currency. Operating profit declined at constant currency from the impact of lower volume, temporary price concessions that we offered to our customers to support them during these difficult times and a small increase in year-over-year bad debt expense.

We were able to partially offset this by strong productivity in both New Equipment and Service segments. In the New Equipment segment, our material productivity in the factories [Technical Difficulty] (00:09:19) for second quarter in a row and in the Service segment, maintenance hours per unit continued to trend down. Cost containment efforts that we launched in Q1 of 2020 also helped alleviate the pressure from lower volume and our adjusted SG&A expenses were down close to $40 million year-over-year. At the same time, we maintain the investment in the business and R&D expense as a percentage of sales was flat versus the prior year.

Our strong focus on operational execution and a favorable segment mix drove 30 basis points of margin expansion, with continued margin expansion in the Service segment. Second quarter adjusted EPS was down $0.03, as a $0.05 decline from operating profit was partially offset by a $0.02 increase primarily from favorable tax rate and lower interest costs. These results were better than we had expected in the previous outlook provided during Q1 earnings call driven by the resiliency of our Service business model and our focus on productivity and proactive management of cost and customer concessions.

Moving to slide 6. New Equipment orders were down 6.8% at constant currency and were flat on a rolling 12-month basis. As order intake continues to outperform the market that was down high-single digit resulting in a 110 basis point increase in global market share in the quarter. Booked margins were down 70 basis points in the quarter and were flat year-over-year for the first half. In the quarter, booked margins were down in Asia and parts of Europe and were partially offset by improvement in the Americas and the Middle East. New Equipment backlog was up 2% at constant currency from growth in the Americas and backlog margin was up slightly over prior year.

Organic sales were down 10.4% with double digit declines in the Americas and EMEA, reflecting the impact of jobsite closures in April and May. Sales in Asia were up 1.6%, as decline in Asia Pacific was more than offset by strength in China. China New Equipment sales were up high-single digits as jobsites reopened and business returned to pre-COVID levels. At constant currency, New Equipment adjusted operating profit was down $46 million and margin contracted 230 basis points, as strong material productivity and cost containment in the field was more than offset by the impact from lower volume and under-absorption of costs.

Service segment results on slide 7 remained strong in the quarter. Number of units under maintenance contracts increased by 1% with units in China up more than 5%. Modernization orders were down 4%, as strong orders growth in China driven by mandated regulatory upgrades in certain markets was offset by lower order intake in the Americas and EMEA. Organic sales were down 3.3% as maintenance demand remained strong while the building shutdowns impacted discretionary repair and modernization sales.

Adjusted operating profit margin expanded 170 basis point and profit grew by $14 million at constant currency, as strong contribution from productivity and cost containment actions more than offset the impact from volume decline, temporary price concessions and an increase in bad debt. Pricing environment excluding the impact of price concessions was modestly favorable. Overall, we closed out a solid first half, in which our organic sales were down slightly more than 4% with flat year-over-year Service revenue and a 70 basis point margin expansion. We are maintaining the execution momentum in the business and continue to make progress on key strategic initiatives; gaining share in New Equipment, driving material and service productivity and containing SG&A costs. And while we face a challenging business and economic environment, our operational metrics are recovering from the lows of April and May.

Turning to slide 8. China has shown a swift recovery as business returns to normal and the rest of the world is following suit at varying paces. We have seen improvement in access to New Equipment jobsites throughout Q2 in every region. Access has largely returned to normal in the Americas and EMEA. While Asia Pacific has shown improvement but it's still facing some challenges in India and Southeast Asia due to government imposed measures. The maintenance business was resilient in the quarter and considered essential in most areas. Access where it was limited has returned to normal levels towards the end of June and early Q3. Lastly, overall repair volumes are still below last year and Q1 but trends are heading in the right direction with a number of service requests from our customers continuing to increase and we expect to see a recovery to pre-COVID levels in the balance of the year as buildings reopen. We are improving our 2020 outlook to reflect strong progress in the first half and these encouraging trends.

On slide 9, we now expect overall organic sales to be down 2% to 4% for the year, up from prior expectations of down 3% to 7% with improvement in both New Equipment and Service versus prior guidance. We now expect New Equipment sales to be down mid- to high-single digits and Service sales to be flat to down low-single digits. In the New Equipment segment, we are assuming varying rates of recovery with the high-end reflecting a slight growth in the second half of the year. In the Service segment, maintenance business has proved to be resilient in this environment and the range reflects differing degrees of delay in discretionary repair and modernization projects 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 flat to down $50 million at constant currency and down $40 million to $100 million at actual currency. At constant currency, the outlook increased by $75 million at the midpoint, reflecting the higher revenue versus prior guidance, strong progress on cost containment actions and a small improvement in Service pricing outlook. We expect operating margin expansion in a range of 10 basis points to 30 basis points.

Adjusted EPS is now expected to be in the range of $2.20 to $2.30 up $0.20 at the midpoint driven by improved operating profit outlook, lower net interest cost, lower tax rate and a reduced share count. We are lowering our full year tax rate guidance to 31.5% from 32% in May and down from 33% on Investor Day. We expect the tax planning work that we're doing to continue to yield benefits and the tax rate to trend down to between 25% to 28% over the medium term.

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 saw in Q2. The high end or a 5% decline contemplates a rapid recovery in Q3 and growth in the back half of the year while the lower end reflects continuing challenges in accessing the jobsites. The EMEA New Equipment business is expected to be down high-single digits reflecting business recovery recovering to pre-COVID levels during Q3 in North Europe and a gradual recovery in South Europe and the Middle East. We are improving the Asia New Equipment outlook due to strong recovery we experienced in China during Q2 and now expect Asia to be down mid-single digits. This reflects the continued recovery in China with varying pace of recovery across Asia Pacific with challenges in India and Southeast Asia while the rest of Asia holds up well.

In the Service business, we anticipate the maintenance business remains stable into the back half of the year with continued pressure on discretionary repair early in Q3 and recovery in the later months of the year and expect the overall maintenance and repair business to be flat to down slightly for the year. While our modernization sales grew in the first half, there is potential for modernization projects to push out into 2021 and we now expect modernization sales to be flat to down low-single digits. Overall, the high end of the 2% to 4% organic sales decline reflects an early Q3 recovery globally and the low end assumes first half conditions to continue into the second half of the year.

Switching to operating profit on slide 11. At constant currency, adjusted operating profit improved by $75 million from the May guidance at the midpoint and is now expected to be flat to down $50 million versus the prior year reflecting the impact of reduced volume from the COVID-19 pandemic, incremental under-absorption of costs and impact on pricing including some temporary price concessions in our Service business. We will continue to offset these impacts through strong material and service productivity and cost containment actions that are tracking as the prior expectations. Foreign Exchange is now expected to be a headwind of $40 million to $50 million for the year and improvement from the $60 million of headwind that we had expected in May, due to strengthening of the euro against the US dollar.

An update on capital deployment on slide 12. We started 2020 with about $1.4 billion of cash on hand and expect to generate between $1 billion to $1.1 billion of free cash flow in 2020 and now plan to pay down $350 million of debt instead of the original placeholder of $250 million in 2020. We still expect to return $260 million to shareholders through dividends in Q2 through Q4 at about 40% of adjusted net income and spend approximately $200 million between non-controlling interest and M&A. These actions will allow us to maintain sufficient liquidity and will enable us to increase the cash on the balance sheet by the end of the year which depending on the overall liquidity conditions in the market can potentially allow us to start share buyback in 2021 after we complete a previously disclosed $500 million of debt repayment.

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. I'm pleased that Otis delivered a solid second quarter despite current COVID challenges while driving our long term strategy as the world begins to reopen. Over the medium term, we expect sustainable growth and global share gain in New Equipment up 90 basis points year-to-date to continue to expand on our leading Service portfolio. We'll continue to make progress on Service transformation, deploying IoT and the digital tools to drive productivity and margin expansion. Although these are unusual times, we will continue to invest to the sustainable level to ensure we stay at the forefront of this industry and adjust our costs structurally to align with our medium term sales outlook and we will continue to drive EPS growth, use our robust cash generation and leverage our balance sheet to create shareholder value.

With that, I'd like Chris to open up a line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from the line of Nigel Coe with Wolfe Research. Your line is now open.

Nigel Coe

Analyst, Wolfe Research LLC

Q

Thanks. Good morning. [ph] Couple of ground (00:22:25) in the prepared remarks, but I just wanted to just go back to the pricing comments. One of your major competitors, I think, mentioned price pressure about 17 times on that call, no doubt I was counting, but maybe just comment on what you're seeing sort of right now in terms of the – some of the bidding pressure that they referred to. Would you agree with that comment? And maybe touch on these price concessions you've been offering to customers on the service side. Kind of is that tracking in line with your expectations and when would you expect that to taper off?

Judith F. Marks

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

A

Sure. Thanks, Nigel. So we have seen about 70 basis points of booked margin impact in the second quarter. That was mainly in EMEA and Asia Pacific. China itself was flattish and the Americas actually had improved booked margin. And as you understand, this flows through to our revenue primarily in 2021. We do expect some pressure. We expected at this quarter, we expect some in the remaining half of the year on pricing because pricing follows macroeconomic trends and this is really why we have focused so hard on cost containment and our productivity initiatives. The only part we don't have in our outlook is any additional activities driven by stimulus and that could also impact pricing probably favorably. So our service pricing is holding up well. Outside of the price concessions, we did get our normal price increases throughout the first half of the year. The price concessions themselves were a little less than we anticipated primarily in the hospitality space, hospitality and retail and we have included those in our outlook for the remainder of this year. So, service pricing is holding up well. Booked margin is down 70 basis points on New Equipment, but again China flattish and we understand what we need to do to drive cost out and drive productivity up.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Great. Thanks. Thanks, Judy. And then on the tax rate, obviously, moving in the right direction and I'm just curious if we have a line of sight on issuing the foreign debt to further maybe optimize that tax rate?

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

A

Yeah, Nigel. So we guided to – in our prepared remarks, we kind of mentioned that. We expect the medium term tax outlook to be about 25% to 28% and that is over the next three to four years. It's not going to be all backend loaded. We expect measured progress over this time period. We're working on several projects. We're evaluating our entire business and understanding where should things fit from right business perspective and what impact does that have the tax rate, so we're working extremely hard and I think we've shown good progress since 2019. We are now expecting this year to be about 31.5%, so 3.5% decline over where we were in 2019. So that's really good progress and then we see a path to between 25% to 28% over the next three to four years.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. Great. Thanks a lot, guys.

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

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Maybe the first question around the overall new install market. One of your peers had mentioned that market getting back to 2019 levels by 2022. Just wondered, if you thought that was a realistic assessment if it differs from your own perspectives at all and also maybe how that sales outlook for the medium term, what's that informing your actions on the cost base in New Equipment? What are you doing there?

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

A

Yeah. Julian, let me try and talk to both of those and I'm sure Rahul will add. We have seen the job sites reopening at a fairly strong pace. Globally, it's over 90%. In April, we were at about a 65% global. Again, the current restricted areas are more so in India and Southeast Asia. So the job sites are reopening. In North America, we are almost totally reopen; but as we reopen we're seeing some different behaviors due to health and safety concerns. So we're making sure we do initial safety startups and obviously we have to separate some of the workforce in terms of how the construction crews are coming back as well.

In terms of what we're seeing on buying behaviors, the orders especially in North America in this last quarter were down. And a lot of the reason they were down was the decisions were just not being made and were being delayed. When we speak to the customers, they're optimistic and they still plan on moving forward with their projects. Additionally, when you look at our end market exposure, we shared this in the appendix, we are far more than 50% driven by residential and we're seeing residential projects grow strongly. So our outlook really does anticipate that we get back to New Equipment levels sometime in 2021 and that we will obviously modulate our costs based on what we see, both the orders coming in second half of this year and then as we see the New Equipment business coming back as well. Rahul?

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

A

No. I think you covered it, Judy. Overall, we've seen – our proposals are kind of holding through the first half. It's been – as you would expect, Q2 is a little bit softer, but over the first half our proposals are holding. China activity's been really, really strong both across infrastructure and the other sectors. And if you look at the market in China, that was up in through – for the first half, it was pretty much up across all sectors of Q2 being especially strong. So, I mean, it's overall – it's an uncertain environment, definitely fluid, but so far the business seems to be recovering well. And as Judy mentioned, the job sites are coming back and that's what we're kind of focused on right now, just making sure that we are executing in the backlog that we have and what will drive our revenue in the near term is obviously the backlog which is – good to see that our backlog is actually up 2% year-over-year through the second half. And then as we look forward into 2021, we'll stay focused on maintaining this backlog growth that we've seen, accelerating the pace of conversion from backlog into New Equipment revenue, driving cost out to ensure that we can stay competitive on margins and deliver strong margins. So that's what we are focused on internally.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Thank you. And then, my second question just around maybe the revenue split, thank you for that split on slide 18 on the end markets. But maybe geographically, 5 to 10 years ago in that European slump, there was a bifurcation between Southern European trends and the north. Perhaps we're seeing a similar bifurcation starting now. Just wonder, if you could clarify how large is that Southern Europe exposure within the overall EMEA sales split? And how different you think the recovery slope might be between that Southern Europe piece and the rest of the EMEA region?

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

A

Yeah. As you know, Southern Europe is definitely a bigger market for us. We have number one position in France, Spain and Italy, so we have definitely a strong presence in Southern Europe and the recovery has been stronger in Northern Europe. Our business in Germany did really well in the second quarter, so that we are seeing the Nordics, German market come – Switzerland come back strongly and Southern Europe is little bit slow as you'd expect given what you saw happen with the pandemic, so that is definitely the case, but even if you look, we did provide some color on the overall industry. But if you look at our European business as well, Europe especially the fact is that close to 70% of our Europe business in Europe, cumulatively EMEA, is residential. So we are a little bit more heavily skewed, a, on the residential side in EMEA versus the rest of the world. So that obviously helps the overall mix and how the various sectors recover and the residential market matters more to us in Europe and probably in some other parts of the world.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Very helpful. Thank you.

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

Cai Von Rumohr

Analyst, Cowen & Co. LLC

Q

Yes. Thank you very much and good quarter. So going back to Nigel's question, I don't know whether it was 15 times but certainly KONE hammered on pricing being an issue, Schindler sort of mentioned it and you don't seem like it's a big, big issue. Is part of that because of the success? I think your target was to reduce material costs. So 3% per year, is that part of it and maybe give us some color on how you're doing in terms of those cost target?

Rahul Ghai

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

A

No. So Cai, listen, we are – again, we gave you the numbers that we have seen. We saw a booked margin and Judy repeated this in response to Nigel's question. I mean, we're seeing the pressure, right. It's like the booked margins were down 70 basis points and you would expect that. I mean, Asia Pacific given what's happening in India, given what's happening in the Southeast Asia and the Indian economy still hasn't opened up and in terms of units that's the second largest economy in the world in the elevator market. So it's clearly an issue, right and we're not hiding from that. And as Judy said rightfully so, the pricing will depend on the overall macroeconomic environment. But if you go back to right from the Investor Day what we're seeing and what we did not build into our medium term outlook that we had provided on Investor Day, we did not build in any margin increase on the New Equipment side of the business. And the reason we did not is we expected the pricing pressures to manifest themselves over this time period. We did not know that would be the second half of 2020 versus 2021, but we knew that they were going to come at some point. And that's why starting last year, we were being so focused on driving material productivity and we set a target for us for 3% over this medium term every year over the next three years to four years. And if you look at the first half, it's great to see that we've done this now two quarters in a row and that is helping.

I mean, if you look at our margin trajectory this quarter and even for the first half, we're basically falling through – our earnings are falling through at the contribution margins. That means we're able to absorb all the under-absorption, any pricing pressure, bad debt expense all through our material productivity and cost containment. So we knew it's going to happen. We didn't know when and I think internally we were focused on taking cost out. So we'll deal with the pricing as it happens. And yes, is it worry? Absolutely it's a worry. But we are focused on things that we can control and making sure that we don't repeat the mistakes of the past when we gave up share because we didn't want to compete on price. So we'll keep dealing with the pressures as they come in the market.

Judith F. Marks

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

A

Yeah. Cai, the share is really, really important and we prepared for this. All four of our regions went up in share and significantly up in the Americas and in China (sic) [significantly up in China] and in general we were up for the quarter, a 110 basis points and then for the half year, 90 basis points. So in a declining market where the segment itself was going down last quarter high-single digits, we took share everywhere.

Cai Von Rumohr

Analyst, Cowen & Co. LLC

Q

And so a final one, everyone talks about share and how do you define share, if you talk about ticking up 90 bps. What are you talking about? New elevators, organic, constant currency, sales; how are you defining share?

Rahul Ghai

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

A

Well, it's in – the way this industry tracks share, Cai, is based on the number of units in the market. So that's how it's done and I think everybody pretty much does it the same way. So we define share based on the number of units we booked in the quarter versus what we estimated the markets to be in second quarter versus – and the first half.

Cai Von Rumohr
Analyst, Cowen & Co. LLC

Q

Terrific. And the last one, service units, you mentioned that you are up 1% and yet you are [Technical Difficulty] (00:35:37) in China, I think, lost 1% because of divestitures. Maybe give us a little bit more color in terms of how you are doing and how those numbers compare the industry as a whole?

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

A

Yeah. Cai, I can't report on the industry as a whole certainly for this year but I can tell you we have an intense focus on growing our Service portfolio. We understand that is the foundation of our business model and we are focused on getting our Otis units back in addition to recapturing other units, driving our conversion rates up, driving our cancellation rates down. So the biggest move we made in the portfolio this quarter was China which went up over 5% in terms of units under maintenance, that's the largest growing market for the portfolio. So we've challenged the team to outgrow what they've done in the past in every region but especially in China.

Cai Von Rumohr
Analyst, Cowen & Co. LLC

Q

Okay. Thank you very much.

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

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Hey, guys. Good morning.

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

A

Hey, Steve.

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Can you just clarify whether the interest expense guidance reflects all the kind of recent and planned moves on debt, and the balance sheet and capital structure?

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

A

Yeah. It does, Steve. So, yeah I mean we increased the debt repayment from $250 million to $350 million this year and we still holding our long term total debt repayment to around $500 million, so we're planning to do $350 million this year and $150 million next year.

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Okay. Great. And then is there anything in the second half when it comes to kind of the profit comps that we have to keep in mind from last year for kind of sequencing third quarter and fourth quarter or should things be kind of pretty smooth on a year-over-year basis?

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

A

No. I think if you look at Q3 versus Q4, Steve, on the New Equipment side, we expect Q4 to be marginally stronger than Q3. The activity is still a little bit slow in some of the larger markets in Asia Pac like you mentioned India, Southeast Asia. And in the US while the jobsites are open, the number of COVID-19 cases are still rising and that sometimes impacts the number of people we have available on jobsite or certain jobsites shut down temporarily. So there's a little bit of still fluidity in the market, but this will be counterbalanced by China to some extent because we are catching up in certain areas in China and [ph] we do (00:38:24) expect China to be strong in Q3, so overall maybe on the New Equipment side, slight skew towards Q4.

And on the Service side, as we mentioned in the prepared remarks, our repair activity is still subdued due to the lower building occupancy. Some of the buildings are not fully open yet and we expect gradual improvement as we go through the year. So on the Service side, we'll definitely have a stronger Q4 than Q3 and that's the higher margin business, so some of the profit to kind of follow similar trajectory.

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

And then one last quick one. I think you guys have some pretty good visibility into what's going on in the in the elevators that your buildings are installed in. You mentioned lower occupancy. Any early reads on kind of any surprising utilization trends of your assets in those buildings despite the lower occupancy due to social distancing like, for example, if you're fitting less people in the elevator, it's going to go up and down more times to carry the same amount of people, I mean. And any read into that utilization dynamic there?

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

A

Yeah. It's still early, but as you know Steve, we have a tremendous amount of remote information from our remote monitoring systems and these are early days. The residential elevators are getting tremendous usage because most elevators people are only stepping in if no one else is in that in condominiums and apartments throughout the world. So the residential usage we know is up. In the more commercial space and office space, we're working with our customers to understand that. We're adjusting some traffic flow algorithms. Our destination dispatch system is being tuned based on customer requests, but as long as a building is open, it's certainly the elevators getting used and maintained and eventually we'll need repair work as well. So early days; hopefully we'll have some more data for you on the next call.

Steve Tusa
Managing Director, JPMorgan Securities LLC

Q

Great. That's great. Thanks a lot.

Operator: Thank you. And our next question comes from the line of John Walsh with Credit Suisse. You line is now open. If your phone is on mute, John, please unmute it.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning, everyone. Sorry for that.

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

A

Hi, John.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Just wanted to dig a little bit into your comments around the modernization market; obviously held in there better than we expected. You called out Asia Pacific. Just wanted to know if it was kind of a return to normal you were seeing with activity or if there was something else that was driving that expected growth and modernization on a regulatory front or anything else there?

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

A

Yeah, John. The major regulatory front activity is a safety regulatory program that's driving significant modernization in South Korea. And it's going very well for us but it is a regulatory program. It's going to be multiple years. In Q1 our sales were up 7% down 1.5% in Q2, but orders for the first half are only down 70 basis points. So our modernization business is actually holding up better than we had anticipated through the first half. And we've tried to put some of that revision into our assumptions for our revised outlook, but Asia Pac between Japan and Korea Modernization is healthy. Korea is primarily regulatory.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thank you for that. And then, I guess maybe going back to Steve's question, as you talk to your customers what is the appetite for them to move to more of a touchless solution and actually upgrade. Are we still in kind of the early stages of having conversations with those facility managers or are you actually seeing them kind of pull the trigger and wanting to move forward with some of those kind of post-COVID-19 investments as they prepare for people coming back?

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

A

So I think we're seeing – and I'll start with China where we've seen the biggest pull to start from purification fans and that's being ordered in the thousands to touchless technologies whether those are using our app for an iPhone or Android to be able to call the elevator or we're piloting some hand gesturing technology, as well as just better traffic flow. So, you see early adopters following both the technology early adopter curve, but also we're seeing it earlier in places that have recovered earlier. So China, it's already – it's being installed. We're seeing good pick up. Where we're seeing in the early adopters in EMEA, the rest of Asia Pac and the Americas are those building managers who really are trying to figure out how not to queue in the lobbies and how to really create a safe and healthy building environment. And it's early, but we're starting to see it's not material in terms of revenue yet, but a lot of people are interested. Some are doing short-term activities but others are looking at major modernizations. And I think it's still to be determined if that modernization budget is going to replace some other modernization they were planning in their capital planners. I think we'll see that come out over the rest of 2020 and into 2021.

John Walsh
Analyst, Credit Suisse Securities (USA) LLC

Q

Great. Thank you for the color.

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

A

Thank you.

Operator: Thank you. And our next question comes from the line of Carter Copeland with Melius Research. Your line is now open.

Carter Copeland
Analyst, Melius Research LLC

Q

Hey, good morning and great numbers. I wondered if you might expand a little bit Judy and maybe there's not enough passage of time and data here, but do you see differences in service quality differentials across the market and do you see that having an impact on retention and cancellation rates? I mean it may be too early to say, but is there going to be any impact there that you think is measurable?

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

A

I think it will be but I think it's early days Carter. And the reason is because, as we look at a lot of our maintenance activities, we did not have all the same quantity of callbacks. As Rahul showed, it's growing again as we go month-to-month, but it's hard to find that kind of compare between 2020 and 2019 and 2018 and before that. IoT is going to make a significant difference. Digital adoption is going to make a significant difference and we're seeing customers now really having discussions with us on what can we know when from a data access from a remote – from an API perspective. And so we see – that's why we're going full steam on Otis ONE and really picking up the pace in the second half of the year to make up for the first half where we didn't have access to all the buildings we needed to install the sensors and the gateway to our cloud, but you're going to see that pick up and we're going to hit that 100,000 units on Otis ONE throughout the globe in the countries we've identified by year end and that is going to drive service quality absolutely.

Carter Copeland
Analyst, Melius Research LLC

Q

And just as a follow-up. The demand on modernization, the flat to down there. Does that represent sort of a step down that we stay there or is there a pent-up demand dynamic there as we look into 2021 and 2022?

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

A

I'm convinced there's pent-up demand. I mean in the installed base in the segment itself, 5.5 million elevators are over 20 years old and are either in need of aesthetic upgrades or technology insertion and major upgrades and modernization. In EMEA alone, there's 3 million units that are over 20 years old. So every year they age, they're all getting usage especially the residential units. And the China modernization opportunity is emerging as well. So, I think all of those converge and the challenge is going to be when does that budget reemerge for the customers to engage? And when do they see this not as discretionary but really as mandatory for their own usage, for their own technology insertions.

Carter Copeland
Analyst, Melius Research LLC

Q

Great. Thanks for the color.

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

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Thank you. Good day, everyone.

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

A

Hey, Jeff.

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

A

Hey, Jeff.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

I was wondering if we could come back to the booked margin discussion, kind of a two-pronged question around that. First, Rahul, you responded, I think it was to Cai's question, on your productivity and other actions that you're taking. So, to be clear, is that booked margin kind of a gross booked margin or is that net of everything you're trying to do the counter pricing pressure?

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

A

No. It is clearly gross. It's the margin we take when we record the order and then everything else we do is obviously to drive that down with productivity offsets and other cost actions.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

And then, obviously, you're just talking about the quarter with that number. Do you have the sense of kind of total margin in backlog; how that's sitting right now?

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

A

Yeah. So couple of points there, Jeff. On the second quarter, our booked margin was down 70 basis points. It's about flat for the first half because if you remember first quarter our booked margin was actually up. So if you average the two quarters, it's kind of flat, so on the booked margin side. On the backlog margin, our backlog margin was actually up slightly, so that was good to see that, not only that is the backlog up 2% but the margin in backlog is also up. So that's a good sign for us.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Clearly. And then just back on the capital deployment, I guess kind of it almost looks like completing the debt reduction, you say, 2021, it almost looks like it could be January of 2021. So given kind of the exit cash balance you're going to have here, just maybe a little more color on what your appetite is to kind of institute share repurchase and/or step up kind of the M&A activity. And I guess on M&A, it's more of a question of availability versus desire. But any other color you have there would be appreciated?

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

A

Yeah. We have a desire for M&A as we've always shared and it's a matter of the right properties coming up especially to add to our Service portfolio in regions where we can achieve the synergies and have the ability to integrate effectively and gain those units on a portfolio. And we continue to look at those niche properties. And as they come up, we've got a deal book that's live and always, always looking. We think that $50 million a year that we shared at Investor Day is still the right placeholder for us and we continue to do very small ones that are – obviously some privately held companies that wouldn't show up. Rahul, do you want to?

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

A

Yeah. So our plan – Jeff, on the share buyback, our plan was always to start share buyback post-debt repayment. So, if you accelerate the debt repayment share buyback and also get potentially accelerated, but the situation of fluid obviously. We're going to watch the overall liquidity in the market. We don't have to repeat or what we saw back in March, April when the access to CP markets got severely restricted. So we've got a strong credit rating. We're not expecting a repeat of that scenario, but to the extent that the liquidity markets – the liquidity stays stable in the market and we accelerate our debt repayment, we're absolutely looking at accelerating the share buyback as well.

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

A

Yeah. Great working capital this quarter. We're obviously going to keep driving the team to drive that free cash flow, really pleased with that performance and obviously the more we generate and our liquidity situation, we will continue to focus on how we can benefit our shareholders.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

I'm sorry. Maybe just one follow up on that. Is the near-term tax rate reduction that you're seeing and realizing more a function of the de-lever or is it more kind of the structural things that you're working on?

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

A

No, it's nothing. The deleverage part is not the reason why we took our tax rate down from 32% to 31.5%; part of our reduction from 33% to 32% that we guided to in Q1 earnings call, that was related to reducing the rate – or finding ways to reduce the tax that we need to pay on repatriation of cash. So we work from that, that led to about 1 point reduction back in Q1; on the Q1 earnings call. This reduction of 0.5 point has nothing to do with finding out ways to reduce the tax on repatriation of cash. This is more structural.

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

A

Yeah. And we're going to continue that structural focus, as Rahul shared in the comments. We see a 25% to 28% effective tax rate in the mid-term; lots of structural activities going on and we view opportunities to get there over the midterm.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great. Thank you for the color.

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

A

Thank you.

Operator: Thank you. [Operator Instructions] And this does conclude today's question-and-answer session. I would now like to turn the call back to Judy Marks for closing remarks.

Judith F. Marks

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

Well, thanks again everyone for joining the call this morning. We're really focused on executing our strategy, managing the risks and driving value for Otis shareholders while supporting our customers and efforts to safely reopen jobsites and buildings. I want to once again thank our colleagues for their dedication as well as those on the frontline fighting COVID-19. Stay safe and well. Thank you.

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