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Otis Worldwide Corp. (OTIS)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Otis Second Quarter 2023 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 it over to Michael Rednor, Senior Director of Investor Relations.

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

Thank you, Liz. Welcome to Otis's Second Quarter 2023 Earnings Conference Call. On the call with me today are Judy Marks, Chair, CEO and President; and Anurag Maheshwari, Executive Vice President and CFO.

Please note, except where otherwise noted, the company will speak to results from continuing operations, excluding restructuring and significant nonrecurring items. A reconciliation of these measures can be found in the appendix of the webcast. We also remind listeners that the presentation contains forward-looking statements, which are subject to risks and uncertainties. Otis's SEC filings, including our Form 10-K and quarterly reports on Form 10-Q, provide additional details on important factors that could cause actual results to differ materially.

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

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Judith F. Marks

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

Thank you, Mike, and thank you, everyone, for joining us. We hope everyone listening is safe and well.

Starting with the second quarter highlights on slide 3. Otis delivered a strong second quarter and a successful first half of the year. In Q2, we grew organic sales high-single digits in both segments, expanded adjusted operating profit margin 20 basis points, and achieved 7% adjusted EPS growth. This performance again demonstrates the strength of our strategy and our ability to execute and deliver.

We have momentum going into the second half and beyond as New Equipment share was up slightly in the quarter and up about 50 basis points in the first half. We grew our maintenance portfolio 4.2% and continue to grow our New Equipment and modernization backlogs. We generated $409 million in free cash flow in the quarter and returned $175 million to shareholders through share repurchases, taking year-to-date repurchases to $350 million.

From an innovation standpoint, this quarter, we launched our latest elevator in North America, the Gen3 Core, designed specifically to address the needs of customers in a large two- to six-story building segment. Gen3 Core is built off the proven design in flat-belt technology of Otis's Gen2 family, while also being equipped with Otis ONE, our IoT platform. Gen3 Core will be manufactured in Florence, South Carolina, and sales will begin this fall.

Here are some exciting customer highlights from the second quarter. In Montreal, Otis Canada was selected to provide 28 units, including 11 SkyRise units to the Hôpital Vaudreuil-Soulanges. Hospitals require reliable transportation between floors at all times and we're excited to be a part of this important healthcare initiative expected to open in 2026. It's our latest collaboration in Canada with general contractor Pomerleau.

In Egypt, Otis will provide a total of 57 units for the iconic tower in El Alamein, including SkyRise and Gen2 elevators, as well as our Link escalators. At 267 meters, this will be the second tallest tower in Egypt and will offer more than 200,000 square meters of housing, as well as services and leisure.

In China, another 280 elevators and escalators from Otis will keep people moving along Tianjin Metro's new line 7. This project will bring the total number of Otis units on the city's expanding subway network to more than 1,800. Since it opened, Otis equipment has kept Tianjin Metro passengers on the move and has been a critical part of the country's transportation network since 1984.

And as the Indian government continues to invest in transportation infrastructure, Otis will install 255 units, including our heavy-duty public escalators and Gen2 elevators for the new Bhopal and Indore Metro. This is the first metro line in the state of Madhya Pradesh and is expected to serve 500,000 passengers daily. All the equipment will be manufactured at our factory in Bangalore.

We made progress on our ESG priorities, and in the second quarter, received Zero Waste to Landfill certification for all three of our Spanish factories from AENOR, the Spanish Association for Standardization and Certification. This is important progress towards our goal of achieving 100% factory eligibility for Zero Waste to Landfill certification by 2025.

In addition, our factory in San Sebastian, Spain received its LEED Platinum certification, the first factory in Spain to receive this designation. The facility opened last year and was designed to reduce environmental impact in the construction and operations through materials used and its waste control system. San Sebastian is our fifth

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factory to achieve LEED certification. We continue pursuing ways we can improve our environmental impact, which is an increasing focus of our colleagues, customers and shareholders.

Moving to slide 4. Q2 results and 2023 outlook. Overall, organic sales increased 9.5%, with all geographic regions exhibiting strong New Equipment organic sales growth in the quarter. And in Service, all lines of business contributed to our best Service organic sales growth performance since spin.

We grew our adjusted New Equipment backlog at constant currency by 5% compared to prior year and 3% to the prior quarter, despite a tough compare on New Equipment orders which were down 12%. We continued a strong trend in modernization with orders up 16% at constant currency and backlog up 14% in the second quarter. This is the fourth consecutive quarter of 10% or greater mod orders growth.

We grew adjusted operating profit by $60 million and expanded margin by 20 basis points. We generated $409 million of free cash flow, a conversion rate of 109% of GAAP net income.

Before sharing our updated 2023 outlook, let me update you on our current geographic outlook for new equipment markets. In Asia Pacific, there's no change to our previous outlook. We expect the new equipment market to grow mid-single digits or better, led by India.

In EMEA, the market is now expected to be down high-single digits in 2023, worse than our prior expectations of down low- to mid-single digits. This decline is driven by Northern Europe, as customer delays and buying decisions persist.

The Americas market has weakened over the past few months, and we now expect it to be down high-single digits in units. From an end market perspective, this decline is driven by multifamily residential coming down from a high level over the past two years, slightly offset by a more resilient commercial market.

And finally, in China, we now expect the market to be down 10% compared to our prior guide of down 5% to 10%. This decline is primarily driven by a lack of momentum as we exited the second quarter at a weaker run rate than we had anticipated.

Despite the weakening of the new equipment markets globally, we've maintained a strong backlog, giving us good visibility to future sales growth. On the Service side, there's no change to our outlook for global installed base growth of roughly 5% led by Asia.

Our strong performance in the second quarter and the progress we've made on our strategic imperatives gives us confidence to improve our 2023 outlook. Organic sales are now expected to be in the range of 4.5% to 6%, with net sales in the range of $14 billion to $14.3 billion. Adjusted operating profit is expected to be $2.25 billion to $2.28 billion, up $155 million to $175 million at constant currency.

Adjusted operating profit at actual currency is expected to be up $125 million to $155 million, including a $20 million to $30 million headwind from foreign exchange translation. We're raising our guidance for adjusted EPS and it's now expected in the range of $3.45 to $3.50, up 9% to 10% versus prior year. Lastly, our expectation for free cash flow remains unchanged at about $1.5 billion to $1.55 billion or approximately 105% to 115% conversion of GAAP net income. We continue to prioritize returning cash to shareholders, and I'm pleased to share we're increasing our share repurchases this year to $800 million.

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Turning to slide 5. As announced earlier today, we're launching a program called UpLift, to transform our operating model to continue to drive sustainable, profitable growth within our business. After three-plus years as a public company, in which we've grown New Equipment share, expanded operating margins, grown EPS, built a formidable backlog and returned approximately $2.7 billion in cash to shareholders, we're designing Otis for the next phase, to ensure high performance and resiliency, regardless of the economic environment we may face in the future. We're launching UpLift to drive efficiency across the organization while continuing to prioritize the customer experience.

Going forward, we expect our sales specialization to continue to accelerate our growth, our innovation cycles to continue at a rapid pace, and our customer intimacy to continue unabated. Our management team is laser focused on ensuring that our operating performance can achieve a new higher performance tier through the transformation of our financial processes, improving our supply chain procurement and rightsizing our cost base where needed, among other aspects of the program.

Throughout the next two years, we expect the program to generate approximately $150 million in savings as we drive efficiency across the organization. Our plan is to update our shareholders at regular intervals on the progress we're making with this program. And ultimately, you'll see the results in better performance, growth, operating profit and returns for our shareholders.

With that, I'll turn it over to Anurag to walk through our Q2 results in more detail.

Anurag Maheshwari

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

Thank you, Judy. Starting with second quarter results on slide 6. Net sales of $3.7 billion were up 6.7% and organic sales were up 9.5%, driven by strong performance in all business lines.

Adjusted operating profit was up $49 million at actual FX and $60 million at constant currency. Drop-through on higher volume, productivity and pricing in both segments and commodity tailwinds were partially offset by inflationary pressures, including annual wage increases, unfavorable New Equipment mix and higher corporate costs.

Adjusted EPS increased 7% or $0.06, reflecting $0.11 of benefit from operations. This strong operational performance and accretion from a lower share count were partially offset by a $0.03 headwind from foreign exchange translation and a $0.03 tax headwind as a result of a tough compare.

Free cash flow was strong in the quarter at $409 million or 109% conversion, up $83 million. The increase versus prior year was driven by higher net income and improved changes in working capital.

Moving to slide 7. In the second quarter, as we noted previously, New Equipment orders faced a tough compare and were down 12% at constant currency. New Equipment backlog, however, continues to trend higher and was up 5% at constant currency versus the prior year and up 3%, sequentially, with all regions being up, providing visibility for sales in the second half and beyond.

Globally, pricing on New Equipment orders was up low-single digits, building on solid pricing improvements from the middle of 2022. Pricing trends improved mid-single digits or better year-over-year in all regions, excluding China. While pricing was down low-single digits in China due to deflationary pressure and the softer market, we maintain price/cost neutrality by focusing on material productivity.

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New Equipment organic sales were up nearly 10% in the quarter, with all regions contributing. APAC grew double digits, driven by strong performance in Korea and India. EMEA grew high-single digits, primarily from Southern Europe. The Americas grew high-single digits as job site delays and field inefficiencies eased. And China delivered mid-single-digit growth by executing on the stable backlog. Overall, we saw solid execution across all regions.

Adjusted operating profit was up $15 million at constant currency. The benefits from higher volume, price beginning to flow from the backlog, strong productivity, and better than anticipated commodity tailwinds were partially offset by continued unfavorable regional and product mix, transactional FX and higher SG&A expense.

Now turning to Service segment results on slide 8. Maintenance units were up 4.2% with growth in all regions, led by China, where we achieved another quarter of high teens portfolio growth. Modernization backlog expanded by 14% with growth across all regions, driven by strong orders growth of 16% in the quarter.

Service organic sales grew 9.4%, the highest rate since spin, with growth in all business lines. Maintenance and repair grew 9.1% from better than expected repair volume. Our portfolio continued to expand 4.2%, and we achieved strong pricing, up 4 points on a like-for-like basis. With strong backlog conversion in the quarter, modernization sales were up 10.9%, with particularly strong performance in Asia, including China.

Service profit was up $52 million at constant currency as a benefit from higher volume, favorable pricing and productivity were partially offset by annual wage increases and higher material costs. Margins expanded 50 basis points, in line with our full year guidance.

Overall, we are pleased with our first half results, where we gained approximately 50 basis points of New Equipment share, grew the portfolio, again, over 4%, increased organic sales by 6.6% and improved operating profit by $67 million at constant currency while continuing to grow our backlog in both New Equipment and modernization. This provides good growth visibility over the next several quarters.

With that, moving to slide 9 and the revised outlook. Starting with sales. With strong Service momentum, we are raising outlook and now expect total Otis organic sales to be up 4.5% to 6% versus the prior guide of 4% to 6%.

Adjusted operating profit growth at constant currency is expected to be in the range of $155 million to $175 million and approximately $15 million increase at the midpoint versus the prior guide, linked to the better-than-expected Service volume.

Service margins are still expected to expand about 50 basis points to 24% and we anticipate New Equipment margins to expand 20 basis points to 6.8%. Overall, margins are expected to be up approximately 30 basis point to 16%, the high end of the previous range.

Adjusted EPS is expected to be up 9% to 10% versus the prior year, within the range of $3.45 to $3.50, an approximately $0.03 increase at the midpoint versus the prior outlook, largely the result of strong operational performance.

Due to our continued cash mobilization activities, we have increased our share repurchase target to $800 million and the outlook for free cash flow is $1.5 billion to $1.55 billion, a roughly 110% conversion.

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Now taking a further look at the organic sales outlook on slide 10. There is no change to the overall New Equipment outlook. By region, we still expect the Americas and EMEA to be up mid-single digits, consistent with our prior guide.

Within Asia, Asia Pacific is performing better than anticipated, led by India, which we expect to offset a decline in China, due to the continuing weak demand environment.

Turning to Service. Organic sales are now expected to improve by 50 basis points versus the prior outlook to a range of 6% to 7% with improvement in all business lines. We are increasing the outlook for maintenance and repair organic sales, now expected to be up 5.5% to 6.5% in 2023, driven by the strong first half repair volume.

Supported by a robust backlog, which is up mid-teens, we are increasing our modernization – our organic sales outlook to be in the range of 7% to 9%.

Moving to slide 11. We expect adjusted EPS growth of 9% to 10% in the range of $3.45 to $3.50, a $0.31 increase for the full year with $0.29 coming from operations.

Overall, with a strong first half behind us, we are well positioned to improve our outlook and deliver solid second half financial performance on the strength of a service-driven business model and focus on operational excellence.

With that, Liz, please open the line for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from Nigel Coe with Wolfe Research. Nigel, your line is now open.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Oh, thanks. Good morning. I hope everyone is well. So, I guess, first of all, I mean, on the New Equipment margins, the clip to the 40 basis points high end, down 20 basis points – sorry, it's a small move, but you haven't changed your growth outlook. It doesn't feel like the mix [indiscernible] (00:20:05). So just wondering what's sort of driving that sort of more kind of [indiscernible] (00:20:10) view, if you will, on margin. And are we still on track for that price/cost tailwind in the back half of the year?

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

A

Hey. Thanks, Nigel, for the question. I guess the first one is, what we've done is we just tightened the New Equipment margin to 20 basis points. So as you noted, right, we haven't changed our sales outlook for New Equipment. But within that, China, which we thought was going to be flattish for the year is going to be down low-single digits.

And as you're aware, China is a higher New Equipment profit margin market, but we're able to offset that with definitely better commodity tailwinds. Initially, we were expecting about $25 million, $30 million, now about $40 million. Pricing, definitely in the second half is going to be better than the first half. You put the two together, I

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think we tightened it to about – which more than offset China, which is why we tightened to 20 basis points on the New Equipment side.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. That's very clear. And then my follow-up is on the UpRise (sic) [UpLift] (00:21:15) program, the $150 million of cost. Maybe just a bit more detail on where you see the opportunities to further streamline the cost base. How much of that $150 million do you think will come to the bottom line versus being reinvested? And then, is this additive to your other programs? I'm thinking things like the modernization margin initiatives, service productivity initiatives, is this additive to those programs?

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

A

Yeah. Nigel, let me take that. And we're calling it UpLift. I think you called it UpRise.

Nigel Coe
Analyst, Wolfe Research LLC

Q

Ah, okay. Sorry.

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

A

But let me take that. First and foremost, I think it's really important for people to understand why we're doing this now, and then I'll get to kind of where the cost takeout's going to be, which is mainly in G&A. So, it will be additive to our other productivity initiatives, as well as our modernization growth.

But where it comes from is, we spun a little over three-plus years ago, and since that time, the team and our colleagues, I mean, tremendous thanks to them. We've gained share in New Equipment. We've driven growth, expanded operating profit margins. We've returned billions in cash to our shareholders and quarter-after-quarter, we've executed our strategy and performed. And I think it's important to know that we're approaching UpLift from a position of strength. I think it's incumbent on leaders to prepare the company to take us to the next level. And that's what we're doing as an executive leadership team across the company.

So we're going to focus really on three areas; the operating model itself to give us more speed and agility. You know we're a tremendously distributed organization with our 1,400 branch offices serving our customers globally. We want that speed and agility to be more customer centric. We're going to streamline processes. That's going to be extremely important. I think it's something we've learned coming out of spin and now through performance that we can be more consistent geographically, and we can streamline our processes from financial processes, all the way through to really how we sell to customers, and we're looking forward to that.

And the third element is taking advantage of our scale, and acting as an enterprise and implementing some pretty significant focus on supply chain and especially indirect. So you add those three together, it adds up to the $150 million we're going to return, which is predominantly through G&A.

Again, it's additive to what we're doing. Anything above that that we generate, we are planning on reinvesting in our business to give us new capabilities, new competencies, to continue to invest in innovation. We've brought more products to market since spin than we had for many years. We're going to continue to do that as we create the connected Otis of the future and take us to the next level.

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Nigel Coe
Analyst, Wolfe Research LLC

Q

Okay. Great. UpLift, got it. Okay. Thanks [indiscernible] (00:24:12).

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

A

Thanks.

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

A

Thanks.

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

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Hi. Good morning. Just maybe the first question around the market outlook and the backlog. Because you took down the market outlook in various regions, but the sales guide, obviously, intact and the backlog is still growing even with orders down. So just trying to understand sort of looking ahead, should we expect the backlog to start to shrink sequentially as that end market pressure starts to be exerted? And do you expect sort of a lower backlog entering 2024 because of the market pressure you called out?

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

A

Yeah. Well, I'll let Anurag answer the backlog, but let me just really straight on hit, we do not expect a lower backlog as we exit 2023 and enter 2024. Really pleased with the 5% backlog growth. And if you go to our first appendix chart, we have a record backlog, which gives us really good line of sight for our future and really helped us drive the sales growth that you saw, the organic growth in both segments. But let me talk to the market and then I'll turn backlog over to Anurag, just so you get a – to give you a little more color.

Let me start in Asia Pac. We expect the market itself on new equipment to still grow mid-single digits. We're seeing really strong markets. We're actually seeing double-digit demand in India and really pleased with how our team is responding there. But think of Asia Pac continuing at mid-single.

The Americas, what we saw in the first half at the market level in units was the first half was down mid-teens. Our view is the second half is going to be flattish to slightly down. So the full year will be down high single for the market itself. The units are slowing. But the Americas market itself was sequentially flat. So we're watching all the indicators, obviously, talking to our customers, looking at Dodge, looking at ABI, but again, watching the Americas carefully and happy to talk about the orders there, as well as we go through these questions.

In EMEA, we say that we're going to be down high-single digit for the rest of 2023. We're watching the rate impact, a little bit of a sluggish market, especially in Northern Europe, think Germany, France and UK being weaker, and it's delays in decision-making uncertainty. The proposals are still going in. The customers, it's a matter of when they're going to make those decisions. Spain and Italy are pretty resilient. And for the segment itself, the Middle East is up low-single digits.

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We're going into Europe with a strong backlog for the second half. And again, when you look at our backlog, we're looking out 18 to 24 months with a backlog of this scale.

On China, the market itself, we're calling down 10%. We started – April momentum was good. May was weaker and we really exited Q2 with the volumes being down in the market itself. So that lack of acceleration that we had been planning on for the book and ship business in the second half really has taken us to the lower end of the range.

The only thing I'll remind everybody, again, that New Equipment market outlook is very different from the Service outlook, which is still solid. It's growing mid-single digit, again, led by Asia, low-single digit in developed markets. Anurag, you want to talk to backlog?

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

Absolutely. Thanks, Judy. Even if we assume there's no orders growth, we would expect our backlog to be up low-single digit by the end of the year. And the reason for that, Julian, is because we tend to book more orders in any given year than we ship as some of the orders are larger projects and multiyear in nature. So clearly, I mean, it's not the right analogy, but if you look at our book-to-bill, it's definitely been far higher than 1. So we booked definitely more orders than we ship over here. But let's even assume if conditions worsen from here and there is a new – our New Equipment orders even slightly decline to even mid-single digit, I think, we will end the year with backlog at least being higher.

More importantly, if you look at our backlog mix today, in Americas, it's still fairly high, which is a multiyear backlog that we have. Asia Pacific is fairly good and that should convert into revenues next year, with China being the highest book to ship. So it gives us kind of confidence as we go into next year to see our New Equipment revenue growing in line of medium-term guidance.

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

Yeah. And even in EMEA, Julian, our backlog is up modestly both versus last year and versus last quarter. So, we're really – we're watching the backlog closely. We've always shared with our shareholders that you should watch us at year-end. It's the best indicator for our next year in terms of top line and bottom line, and that's – we expect this year to be no different.

Julian Mitchell
Analyst, Barclays Capital, Inc.
Q

Thanks very much. And then just a quick follow-up as that was a very thorough answer. Just looking at seasonality within the second half, normally, your earnings are down slightly sequentially in Q4. I think, consensus as you sort of – up in Q4 sequentially. So maybe just is there anything different you're calling out on sort of Q3 versus Q4 earnings this year because of price cost or something like that?

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

Yeah. So if you kind of look at the second half of the year, for the first six months, we did about $1.72 of EPS, which means $1.76 in the back half. And I think it's pretty equally split between Q3 and Q4, Julian, in terms of our EPS split. If you look at New Equipment, and I'll just start with New Equipment and go on to Service. We expect about 3-ish percent growth in the second half of the year. I think it should be kind of equal between the two

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quarters around that. We're going to see commodity tailwind pricing to the tune of about $30 million, $40 million. Obviously, a little bit of that is more towards Q4 than Q3, but the margin rate, which is about 7% should be between – in Q3, Q4 shall be no difference between that.

Now if you look at Service, we are doing $40 million, $50 million of operating profit increase every quarter. We expect that again in Q3 and Q4. Maintenance continues to do well with the pricing, as well as the portfolio growth and we're converting the mod backlog. So, I think, we're in a pretty good run rate over there. And, obviously, there's a little bit more of corporate expense headwind in Q3 versus Q4. So you put all the puts and takes over there. I think the cadence between Q3, Q4 from an EPS perspective should be pretty similar.

Julian Mitchell
Analyst, Barclays Capital, Inc.

Q

Great. Thank you.

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

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hello.

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

A

Hey, Steve.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Hey. Sorry, thought I got cut off there for a second. Just a question on China. So this market is seemingly getting revised down just this – whatever recovery was going to come seems to be deferred. There's seems to be mixed messaging on stimulus. I mean, I guess, first of all, what's your view on how that market will evolve in 2024?

And on the services side, isn't there a bit of like a lag as to when you can go after converting those into service agreements? So, like, we should be thinking about those opportunities as a two-year lag to the market? And at what stage, if this market remains down, do you have to get a little more aggressive to tweak up that equation of units coming up for conversion versus conversion?

Because obviously, if the market's down 10% and a couple of years later, you're still growing your conversion, that could still mean negative units under management if this thing kind of continues to bleed lower? Just curious how you're evaluating that equation.

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

A

Yeah. Let me try and address kind of multiple items there. First, let me start with the Service business. This was the eighth straight quarter we had mid- to high teens portfolio growth in China. And Sally Loh now leads our China organization and she's really been driving that. We are now at 350,000 units on our portfolio in China, which is a pretty big step-up from when we made this commitment to grow our Service business. And it is driving returns and it's – we're increasing the conversion rates as we go.

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Our China – even though the segment was down 10% in the second quarter, Steve, we were down 5%. So yet another quarter of market share gain in New Equipment which bodes well for the two-year warranty and then for the conversions for us as well because, even though there may be less units, our strategy to open service depots to have the ability to drive the service conversion, shipping Gen3s with Otis ONE connected is – at the same time, we're accelerating our conversion rates versus what we had traditionally had in the past. So even if the volume goes down a little, our rates will offset that. So that doesn't really get me concerned.

In terms of what we really changed in the second half, it was – we had expected things to tick up, especially on the book and ship business. And as we exited the second half, we just hadn't seen the momentum. Now like you, we've heard out of Monday, out of the [indiscernible] (00:34:37) a different tone. We have to see what that translates to. I'm cautiously optimistic that once that tone is set from Beijing, there's positive potential that, that – especially in the larger tier cities really starts happening and sentiment changes.

But our outlook did not assume that if that – if and when that happens, again, being cautiously optimistic, obviously, we're prepared for it. We've got the capacity. We've got the sales channel, and we've got the product and innovation to be able to deliver as soon as that picks up. The state-owned enterprises are still doing well. They're still growing. They are buying the land. And that's why, again, we think we've done really well with our strategy on key accounts and growing share.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Great. Thanks. And then just one last one for Anurag. With the orders down potentially here in the second half, how should we think about the progress flow or the contract liability flow through the cash flow statement?

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

A

Yeah. It's – I mean, with orders being down, obviously, there's some – if orders were to be down. Firstly, we're not saying orders are going to be down in the second half of the year. Obviously, it will come with lower advanced payments for sure.

However, as you can – we built up a fair amount of receivables in the first – because of the higher revenue, and that should kind of unwind into the second half of the year, right? So from a cash perspective, I think we will be fine over there, Steve. Yeah.

C. Stephen Tusa
Analyst, JPMorgan Securities LLC

Q

Great. Thanks a lot.

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

A

Yeah. Thanks.

Operator: Our next question comes from the line of Jeffrey Sprague with Vertical Research Partners.

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Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Thank you. Good morning, everyone.

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

A

Hey, Jeff.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Just coming back around to price, Anurag, I think you gave us some good color on price on orders on New Equipment. Just wondering if you'd give us a little color on what's coming through in revenues at this point on New Equipment side and how that might build over the next two or three quarters.

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

A

Great. Great. Jeff, so if you look at – let me start with the second quarter first now. On the New Equipment side, we saw about $5 million of pricing coming through to the bottom line, and which was encouraging. We did expect more of it to come in the second half. And in the second half, we expect about $20 million of that to come through.

So if you look back now, it's been sixth consecutive quarters of price increases that we've done, and our backlog margin is up by over 100 basis points today. And if we kind of go through the course by the end of the year, we should see that backlog margin tick up a little bit more as we flush out some of the older orders with the older prices and the new and this mid-single-digit price increase continues.

If that happens, every 100 basis points of backlog in price increase should bode to about 50 basis points or about $30 million, $40 million for next year. So we should kind of see that come through more next year. So I think we're just beginning to see the price of New Equipment coming into the revenue, and that should tick up for the next few quarters.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great. And then maybe we could just get a little more color on mods. Obviously, it's very robust and creates some margin headwind as you do that work. You seem to be kind of managing that quite effectively.

But my question is really more around what the back end is looking like on the mods. Are you seeing higher service retention on the back end, higher revenue per unit on the back end, just how kind of the mods is really playing into your overall service portfolio growth strategy?

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

A

Yeah, Jeff. Listen, we're really pleased with mod and how it's developing. And I think it's something – I know it's something we're going to be talking about for many quarters to come as – we've added it actually as a fifth strategic imperative at our company just last month or in May and very much focused on making it more like our New Equipment business, which means you're going to see margins expand even though right now, it's dilutive in the Service segment.

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So pleased with the quarter. Again, our fourth consecutive quarter of orders up over 10%, strong backlog. I would call Asia as the standout in mod. We had great volume in some major projects in Asia Pacific in the quarter, Japan, Korea, Hong Kong, India. And China is on a highly accelerating path due to their [ph] MX volume, our MX mod (00:39:15) product we have, and you're going to continue to see that grow as units continue to age in China.

So we're optimistic about mod. As I said in the last call, we're going to approach it by taking everything we've learned in New Equipment and Service and making it more production ready versus custom. And I think that's going to benefit us in terms of margin expansion as we drive more revenue through it.

Once we do a mod, our ability to retain that and put that – keep that on Otis Service is in the high 90s. So, much more significant than the conversion rates even in our industry-leading retention rate. So that's why mod's important to us. It not only gives us additional customer intimacy, both for the units that were on our portfolio, it lets us bring other units back to our portfolio, drives great customer value, energy efficiency, gets them ready for another multiple years, especially as you think about all the buildings now that are being repurposed. There's a huge amount of opportunity for us as well with the offices changing to multiuse. So mods going to be something we talk about for a while going – for almost consistently now every quarter. And you're going to see us continue to deliver on that, both in the orders, the backlog and then most importantly, starting that service clock all over again.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Great. Thanks a lot.

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

Nick Housden
Analyst, RBC Capital Markets

Yeah. Hi, everyone. Thanks for taking the questions. So it's been another strong performance from repair. I was wondering if you could just remind us how much of maintenance and repair is the repair piece specifically and how sustainable the growth is, because I think it's been a couple of quarters now where the growth has surprised to the upside. So I'm wondering if maybe it's just a structurally stronger market than you maybe thought previously. That's the first one. Thanks.

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

Yeah, Nick, good to hear from you. Hey, we don't disclose the difference between maintenance and repair, really strong repair this quarter. And we keep waiting for the quarter where it's going to slow down. When you go back probably six quarters, we saw a bounce back when office use started picking up post COVID, because we had a little bit of a downturn in the early COVID days. So it's been a good strong six to eight quarters.

But again, as people potentially put off some discretionary mod decisions, their units are still aging and need even more repair. So really pleased with repair globally. It was strong in every region. And we're not sure how long this can keep up. So we think we've got it tuned appropriately in the outlook, but I'll let Anurag talk to that from an outlook perspective.

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

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Yeah. I think – I mean, just a couple of points to add over there. I think the team has really executed very well on the repair side, I mean, after two years of double-digit growth. As we entered this year, we thought that repair would be a low-single-digit growth. So if you look at our outperformance on the Service business, Nick, it's largely because of repair. Our maintenance portfolio is growing at 4.2%, albeit price on a like-to-like basis of 4%.

If you adjust for mix and churn, it's a 200 basis points. So maybe maintenance is more than high-single digit. So repair has definitely grown double digit in the first half of the year. And it's not only because of coming back to work, it's just executing on a very good strategy over there.

On the second half, the reason you see a step-down in the Service revenue is because maintenance continues to grow at the same clip, modernization backlog converts as we're just assuming repair is going to be flattish. Now, we may be a little bit cautious over there. If we continue to execute well, there could be a little bit more upside on the second half of the year.

Nick Housden
Analyst, RBC Capital Markets

Q

That's great. And then maybe just on Otis ONE. Can you just provide us with an update on your kind of general efforts on connectivity and how that's feeding into some of the metrics like retention and conversion, whether there's been any impact on pricing or profitability and kind of when we might see that if we haven't already. Because I know you've got a slightly different strategy to one of your peers who's maybe pricing for it a bit more directly already. So just curious to hear how the IoT operation is going.

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

A

Yeah. We're really pleased. The Otis ONE units are making a difference. We are shipping all of our Gen3s with Otis ONE and our new Gen3 Core, we'll have that in North America, the new product we announced this quarter. We're driving a much larger volume of Otis ONE this year because of all the shipments that are happening and because of all the conversions in China that are happening. So where in the past, we would tell you about 100,000 a year, that number is going to be up significantly more in 2023, which is what continues us along that journey in our medium-term guide.

Right now, we've got over 800,000 of our units connected in general, more than just Otis ONE. But now, Otis ONE is picking up a bigger proportion of that, and you'll see far more than 100,000 units this year connecting. It is making a difference. If you look at China alone, I would tell you, it's – part of their significant service productivity, the majority of that is being driven by Otis ONE. Our running on arrivals are down across the globe and that we are getting – any time we have a connected product, our ability not just to convert but to retain that, especially from the ISPs who really – they don't want to come into an Otis elevator that's got an eView screen and figure out how to maintain that. And they can't offer that same connectivity.

So we provide all those numbers on an annual basis. We'll do that in fourth quarter, but it is an integral part of our strategy. It is working. It's helping us with Service pricing. And as Anurag said on service pricing, like-for-like we're up 4 points. So we're up from last year. And honestly, I've got to give EMEA incredible kudos. They're up mid-single digits this year in Service pricing, and Bernardo and the team there are doing a great job on that. But a big part of that is being connected.

I was in Portugal a few weeks ago with our team, more than half of their portfolio is connected and their Service margins are outstanding. So it makes a difference. Our strategy, again, to define that connection versus having people – customers opt in from a subscription. We're getting subscription services, too. But again, we chose to

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invest the CapEx and we chose how we were going to deploy Otis ONE. And I would tell you, you're seeing it in our Service margins.

Nick Housden
Analyst, RBC Capital Markets
Q

Great. Thank you very much.

Operator: Our next question comes from Josh Pokrzywinski with Morgan Stanley.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC
Q

Hi. Good morning, all.

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

Hey, Josh.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC
Q

Judy, I want to pick up on a couple of things you already touched on, and I apologize, I jumped on a little late, so you might have covered this on the China question. But how are you seeing the divergence between national accounts and maybe more of the volume business in terms of where the weakness or where the pricing pressure is coming? Obviously, kind of downstream implications for what that conversion will look like.

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

Yeah. No, fair question, Josh. Listen, we call them key accounts, which are the large developers. Our team has continued to develop those key accounts. And as a matter of fact, our portion of national or key accounts that are now state-owned enterprises is significantly larger than the private developers. So, that's really making a difference for us.

The Tier 1 and Tier 2 cities continued to outperform not just the segment but also outperform for Otis versus the lower-tier cities. But in the lower-tier cities, it was volume for us and our team performed pretty well. As you look at the second quarter, the positive segments in China were the same as the first quarter, infrastructure and industrial, and the weakness was more in resi and commercial.

But I think we – I like the strategy we're on, again, having those state-owned enterprises and then we'll – we're seeing what's going to happen again with the government policy, with the tone that's being set and then how these policy eases, whether it's mortgages, lending rates or, again, houses, it's just the whole philosophy of housing is for living versus investment. That phrase was no longer used on Monday after many years. So, we're watching it carefully. We think we've got the right tuning for the second half. If there is an upturn with either stimulus or just sentiment helping on volumes, we're ready and you'll see it flow through.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC
Q

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Got it. That's helpful. And then just shifting over to the mod business and Jeff's question. I know you guys have aspirations to bring up those margins over time. Obviously, your conversion rates or your attachment rates are good on the back end.

Is this a function of scale and sort of ramping up volume on this more standard work business versus customization? Is it more price discipline? Sort of what are the key either milestones or initiatives that you need to do to bring the margins to that up? Or is it simply just a waiting game of getting us through the backlog?

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

A

Yeah. Great question, Josh, and I think you answered it in a bit of everything, right? So, if you kind of look at our mod business, sort of just to level set everyone, firstly, it is our lowest margin segment today, even relative to New Equipment and obviously repair and maintenance.

But as we standardize the products, as we build scale, and as we kind of get a more sustained go-to-market strategy, we're already seeing these margins pick up because we're getting scale.

So, we are fairly confident that the trajectory that we are on right now that you should see mod margins pick up over the next six to nine months, and overtake the New Equipment margin as well. So, it's on a good track right now.

Joshua C. Pokrzywinski
Analyst, Morgan Stanley & Co. LLC

Q

Great color. Thanks, guys. Best of luck.

Operator: Our next question comes from the line of Joe O'Dea with Wells Fargo.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning. Thanks for taking my question.

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

A

Yeah. Thanks, Joe.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

I wanted to start just on the – circling back on the orders backlog kind of revenue dynamic and just to understand really what you think about in terms of the revenue implications, with some of the changes in the end market views for the year obviously, not impacting how you're thinking about 2023. I'm not even really sure if it's impacting how you're thinking about 2024. And so, just as you think through what's happening out there, and I'm not sure how much of this is supply chain improving, project execution improving, folks that don't need to maybe order as far in advance versus things like interest rates and credit. And so, as you just think about the past few months and then the revised views on some of the demand trends in the markets, if you can sort of translate that to any kind of revenue implications right now.

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

A

Yeah. So let me just touch on a few at the top level. Supply chain is improving, and you're seeing that come through with the volumes we're being able to ship, and that's been helpful. As Anurag said in his opening remarks, commodities are improving as well. We had about a $15 million tailwind in the second quarter, and we've upped our outlook for commodities as well. So price is up, commodities is up, supply chain is improving, that's all fairly positive.

Our backlog, again, is at a record. And we – it really will see us through 2024 with some certainty, with probably the question mark being on China, and when China bounces back and/or at what level. Our China team has done an incredible job on material productivity. And even though pricing is extremely competitive in China, we have hit at least price/cost neutral. The price/costs are slightly positive in China through the first half of the year. So that's going to – if the market doesn't change and there's no stimulus, we'll adapt and continue to change our cost structure. If it does come back, we're ready.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

And then – oh, thanks. Go ahead.

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

A

No, go ahead, Joe.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

I just wanted to touch on the pricing comment as well. And so just trajectory of pricing in China, has there been any indication of stabilization recently? And then also in developed markets, are you seeing any pricing implications just from maybe a little bit lower demand patterns, as well as costs starting to improve?

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

A

So China pricing is very competitive. But no one has yet taken it down to being unrealistic or undisciplined. So it is the most challenging place for us to get price. And I think that's – you see that market wide. Everywhere else in the matured and the emerging markets, we're seeing good price, and we're seeing rational competitors doing the same things.

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

A

Yeah, exactly. I mean, we are still seeing mid-single-digit price increases in EMEA and Americas and low- to mid-single digit in Asia. Now, if commodity costs do come down and material productivity comes down, you could see a little bit more pricing coming down. But the key metric here is price/cost. And I think we're going to be neutral to positive. As of now, we are. And let's see how this trend continues. But so far, it seems quite rational.

Joseph O'Dea
Analyst, Wells Fargo Securities LLC

Q

Thank you.

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

A

Liz?

Operator: Our next question comes from the line of Gautam Khanna with TD Cowen.

Gautam Khanna
Analyst, TD Cowen Research

Q

Hey. Good morning, guys.

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

A

Good morning.

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

A

Hey. Good morning.

Gautam Khanna
Analyst, TD Cowen Research

Q

Just to follow up on just the dynamics on 2024. I was curious, do you have an early read of where pricing might head portfolio-wide in 2024 relative to 2023? And then secondly, have you seen any indications of backlog stretching, whether it's decommits or just timelines extending across any of these markets where orders have been a bit softer? Thanks.

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

A

Yeah. So decommits don't really happen based on kind of nonrefundable deposits in our business. So people don't double order and there's not a lot – we do measure jobs that – and we keep a careful eye on jobs that decommit, it's a very small, low-single-digit, at most, percentage globally of the 10,000 installations that are going on somewhere in the world every day. Are there times – and we experienced this in the past, where there have been some labor challenges from other trades and the jobs have slowed down. That seems to have gone away in the Americas. So we're not seeing that stretch out.

So we either see it, Gautam, at the beginning when we've done a proposal, we've been verbally awarded, but it doesn't go to a booking when we get that deposit because of potentially rates and things like that, and we're watching that carefully as well. I think it's too early for us to talk about 2024 pricing. We're going to focus on the second half and keep building our backlog strong and executing on that backlog.

Gautam Khanna
Analyst, TD Cowen Research

Q

Thanks.

Operator: That concludes today's question-and-answer session. I'd like to turn the call back to Judy Marks for closing remarks.

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Judith F. Marks

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

Thanks, Liz. Our results in the first half reflect the continued execution of our strategy as we remain focused on ensuring we continue delivering value for our shareholders in the balance of 2023 and beyond.

Thank you all for joining the call today, and please stay safe and well.

Operator: This concludes today's conference call. Thank you for participating. You may now disconnect.

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