Rheinmetall AG
Investor Relations
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Transcript

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Rheinmetall AG Conference Call

00:00:01 Operator

Good afternoon ladies and gentlemen and welcome to the Rheinmetall AG conference call regarding the full year results 2016. At this time all participants have been placed on a listen only mode. The floor will be open for questions following the presentation. Let me now turn the floor over to your host, Armin Papperger.

00:00:20 Armin Papperger

Thank you very much. Ladies and gentlemen, my colleague Helmut Merch and I welcome you to Rheinmetall earnings for 2016. As always, we have prepared a couple of slides to walk you through last year's highlights and financials. After the presentation you will have the opportunity to ask your questions. Before we kick off I would like to draw your attention to the safe harbor statement on the following page.

2016 was a very good year for Rheinmetall. We have fully achieved our guidance, lifted sales to a new record level of €5.6 billion and increased our EBIT to €353 million. Even more important is the excellent cash conversion. Operating free cash flow is five times higher than last year and now amounts to €161 million.
A positive message to our shareholders: we will propose a dividend of €1.45 which represents a payout ratio of 31% and a material increase of 32% compared to last year.

Starting in 2015, we fostered a New Technology Initiative. I am pleased to tell you that the entrepreneurial spirit in our workforce has generated some very interesting ideas, of which I will show you some in a minute.

But first, let’s switch to page 4 and get to the figures in detail: Over the last three years our group has continuously recovered from earnings in 2013. We have seen a steady increase in sales and earnings since then. 2016 continued this development with 8% higher sales and 23% higher operational earnings. We are very pleased that we are able to present another strong improvement in operating free cash flow after the convincing turnaround in 2015.

On page 5 you see the improvement on the bottom line. Development of our net income is predominantly driven by the improvement in operational performance, also reflecting first signs from lower financing requirements. The under-proportionate increase in earnings per share is related to the lower average number of shares in 2015 compared to 2016. Reasons were the capital increase in 2015 and the reduction of treasury shares in 2016.

Subject to the approval of our shareholder meeting, the dividend payment will amount to €63 million in total. It represents a dividend yield of 2.3% based on the year's end share price of 63.90 Euro. The payout ratio increased from 28% to 31%, in line with our dividend target of a payout ratio of around 30%.

Let´s go to page 6. As you might imagine, we are happy with the profitability of our Automotive business. A margin of 8.4% is an excellent figure. The main driver once again was our Mechatronics business. With our products - aiming at the ever increasing demand for emission reduction and performance optimization - we have the right answer for the market. Brazil continued to be a challenge, which we are addressing with further cost optimization measures. Large-Bore Pistons showed reduced profitability which reflects lower demand due to the weakness in the underlying oil and mining businesses.

Last year, we widened our Mechatronics exposure in China and India and established a new subsidiary for our Aftermarkets division in Ustí in the Czech Republic.

In the course of 2016, electromobility gained influence on our order book. We delivered the first innovative products for e-driven cars to our customers.

Let's now go to the defence segment on slide 7:

All key indicators have improved. Sales grew by more than 10% and the margin increased by 1.5 percentage points to now 5%. Our order entry provides confidence for the next years. Furthermore, there are multi-billion vehicle programs in Australia, in Germany and the United Kingdom, where we are down-selected. We have demonstrated the competitiveness of our products to reach the final stage. But don't get me wrong, we still have to win these tenders.

We underlined our innovative capabilities with the presentation of the Lynx, an innovative infantry fighting vehicle and the next generation high-pressure gun for main battle tanks, just to mention a few of our new innovations.

With the set-up of new joint ventures in the United States, Poland and Turkey, we have progressed well with our internationalization strategy in order to access new markets and to lower our dependence on the domestic market.

On page 8, you see there that Capex and R&D remain important pillars of our innovative strength. In 2016, we invested €283 million or 5% capex on group level. In the year before, we invested €310 million, but that included the expansion of the castings factory in Neuss and a new building for Aftermarket in Ustí. Additionally, 2015 saw the majority of the investment for the new company headquarter in Düsseldorf of about €10 million.

R&D ratio has remained with 4.6% stable over the last years. Total spending increased by €19 million to €258 million, of which 68% applied to Automotive and

32% to Defence. As always, the figure for Defence does not include customer-funded R&D. You see that also Defence now has higher spending.

On the next two slides, I would like to present to you some of the results of all these efforts:

If it comes to provide our customers with innovative products, we work on the first line in both of our segments. For example, the markets for public security and electromobility have attracted increasing attention in the recent past.

Page 9 exhibits a couple of examples which we have introduced into the market last year. Although they are volume-wise still small, we think that both markets offer interesting potentials. Especially in electromobility, it is becoming evident that we are at the beginning of a new era.

On page 10, I would like to give you an update on the New Technology Initiatives which I mentioned a few minutes ago. There was Cyber Security: we have now started to market the products on network security. First market reactions have been positive and we have now started testing together with customers. So we have two products in testing.

3D printing belongs to those cross-segmental technologies with great potentials. In the Automotive field, we have already delivered first prototypes. Panoview was presented just recently at the IDEX in UAE and is a visualization optic for tank crews but also for the navy and other users with a 360° view, offering better ergonomics than monitors. It’s basically the introduction of augmented reality in the turret. I have just mentioned those examples to give you a flavor of our spirit and innovation culture. Now I hand over to my colleague Helmut Merch, who will introduce you to the financial details 2016.

00:09:11 Helmut Merch

Thank you very much! Also a warm welcome from my side and now please join me for the next couple of minutes, starting with slide number 12.

Let me first give you some highlights on group level. In the fourth quarter Rheinmetall achieved an operating margin of 10.1% after 9.2% in Q4 2015 indicating a solid quarter in both segments. The good performance allowed us to turn high sales and earnings into a stronger cash flow. In Q4 2016, cash flow generation was outstanding and increased by €164 million to €463 million.

Let’s flip to page 13 to dive into the cash flow bridge.

For the full year 2016, operating free cash flow was more than 5 times higher than in 2015 and came out with €161 million. The most important contributor was the higher net income, benefiting from better operational profitability and lower interest expenses. Reduced D&A and lower capex contributed almost equally to the improvement of the cash flow. The position "others" added another €24million, mostly related to deferred taxes and various changes in other provisions. Working capital development in the full year was flat, however more efficient, since sales increased by 6%. Working capital to sales ratio improved by 0.9% to 15.9%. And by the way, both segments contributed equally to the operating free cash flow.

On the following page number 14, I would like to present to you our current financial status: At the end of the last year our net-financial debt changed signs and we are actually reporting a credit balance. We are currently taking our preparations for the maturing €500 million bond in September by evaluating market opportunities. Given the prevailing interest environment, we are confident to further reduce our financing cost. The annual interest payment for our bond of actually €26.3 million for the coupon of 5.25% will be definitely reduced with full impact from 2018 onwards.

Now we turn to slide number 15. And the key messages are the following:

1. The increased profitability allowed us to improve equity by €219 million and to turn net debt by €100 million, from debt position of €81 million to a credit position of €19 million.
2. Pension provisions increased by €58 million, mitigated by a €15 million CTA-contribution. Further €15 million were used to fund the provision for pre-retirement part-time work.
3. With a return on capital employed of 12.3% we exceeded weighted average cost of capital for the group before tax of 10.1%, in other words, we earned our cost of capital and created value.

Ladies and gentlemen, I would now like to turn to the recent developments in our segments, starting with Automotive on slide number 17. As already mentioned by Armin Papperger, Automotive had another very pleasant “drive” in the last quarter. Sales increased by €29 million or roughly 5% which represents almost half of total sales increase in full year 2016. This brought along a strong earnings momentum with a quarterly result of €60 million, mainly impacted by the positive development of Mechatronics. The Q4 EBIT margin reached 9% and all of this favorably impacted operating free cash flow.

As you can see on page number 18, especially on the left side, global light vehicle production in 2016 rose by 4.9%. This development was strongly impacted by China. Without China, global light vehicle production only increased by 1.4%. The light vehicle business of Rheinmetall Automotive grew by 5.0% which means, we again slightly outperformed global light vehicle production in 2016 on a like-for-like basis excluding our Chinese Joint Venture.

Sales in our non-light vehicle business decreased by €24 million or roughly 3%. This part of our business suffered from the lower demand mainly for large-bore engines and for trucks.

Slide 19 shows the breakdown of sales by customer and by region: With regard to consolidated Automotive sales, Ford is our biggest customer followed by Volkswagen Group and Renault/Nissan.

Regarding our regional portfolio: Europe still accounts for two thirds of total sales and Asia for 19%. Including the Chinese joint ventures, Europe would represent 55% and Asia came out with 29%.

Page 20 provides you a detailed view on the divisions: Mechatronics´ sales went up by €77 million or 5% to now €1.527 million, especially driven by demand for solenoid valves and pumps.

Operational earnings advanced by 20% to now €142 million. The margin for the full year reached 9.3% this year. Sales in Hardparts decreased by €31 million of which €28 million referred to the first 9 months. Earnings declined by 15% to €62m.

Most of this decline was related to the receding sales in Brazil with a minus of €18 million. Furthermore, we saw the weak development in the business unit Large-bore Pistons with minus €15 million; here we were faced with low demand from oil and mining related industries.

The negative earnings impact from Brazil accounted for €14 million and from Large-bore Pistons with €4 million. Our equity companies in Hardparts hat a positive mitigating effect with an earnings contribution of €33 million compared to €26 million last year. From this €33 million €24 million resulted from our Chinese joint ventures. In 2015, this contribution was €19 million.

The Aftermarket business saw a growth of 7% to now €305 million and profitability stood at 8.9% compared to 9.7% in the previous year, still burdened by the start-up cost of around €3 million for our new plant in the Czech Republic.

On slide 21, we highlighted our business activities in China. In China, light vehicle production grew by 14% last year, and sales of our Chinese activities grew in line with sales in local currency. However, the weaker Renminbi reduced the figures in Euro; here growth amounted to only 7%.

EBIT in our Chinese factories increased from €53 million in 2015 to now €71 million. While the joint ventures generated €62 million or 27% more compared to last year, our wholly foreign-owned enterprises doubled their earnings contribution and generated EBIT of €9 million. So all in all, profitability of our joint ventures increased from 6.2% to now 7.5% and of the wholly foreign-owned entities from 4.7% to 8.3%.

I am now leaving Automotive and move on to Defence with slide number 23.

As always in this segment, Q4 showed with 35% of total sales the strongest performance of all quarters in the course of the year. Order entry in Q4 2015 was boosted by large single orders from Mexico and by the Boxer order from Germany. So in Q4 2016 our order intake was a little bit lower. On the back of higher sales, we enjoyed a positive leverage and increased our profits by 14% to €115 million compared to Q4 2015. The quarterly cash flow was even better and rose by 20% to €319 million.

Continuing with slide number 24, I would like to dive a bit deeper into the operational development of the divisions in 2016.

Weapon and Ammunition increased sales by 26% and moved EBIT-margin from 8.4% to now 9.7%. Electronic Solutions saw slightly lower sales and earnings with a stable margin of 3.4%. And our Norwegian subsidiary is still generating losses, on a similar level as 2015. Our division Vehicle Systems began with the ramp-up of the Australian truck order and benefitted from rising economies of scale. A sales increase of almost €200 million to now €1.4 billion was accompanied by a margin rise of almost 2 percentage points to now 2.1% reflecting an operating leverage of 12%. So within our Vehicle Systems division our military truck business clearly marked its turnaround. On the consolidation and others line, figures were impacted by the investment in our international network and by losses in our engineering joint venture.

For an analysis of the order situation let us turn to page number 25. Order intake increased by 13% to €3.05 billion. The region with the highest growth was Asia/Middle East and Australia. The fact that order intake from Europe increased from 45% to 48% underlines the gradually increasing demand for defence products in our home region. The order back log increased by 4%, the share of Asia remained stable with 41%, and Europe increased slightly from 37% to 38%.

Let's now have a short look on implications of the back log for future sales on page 26.

The order back log at the end of 2016 stood at €6.7 billion representing an increase of €234 million compared to 2015. Due to the ramping up of large orders this figure declined in Vehicle Systems, whereas order backlog in Weapon and Ammunition rose by more than €100 million and in Electronic Solutions by almost €250 million. Our order book includes sales of €2.3 billion for the current year and this figure stands at the same level as one year ago. Like in 2016, we are pretty confident to achieve further orders with sales execution in the course of this year.

For the years 2018 and following, sales of around € 4.4 billion can be expected based on our existing order book. For the outlook, I will now hand over to our CEO and thank you for your attention!

00:22:41 Armin Papperger

Thank you, Helmut. I would like to continue with slide 28 and give you a short survey on the defence market.

As you know, in the Eastern parts of Europe, concerns about potential threats have increased over the past years. The political pressure on European NATO-members to take more responsibility and to increase defence budgets is rising. In Germany, the mindset of our political leaders has changed and enhanced the readiness to endow the Bundeswehr with better and more equipment. Our armed forces have to prepare for a more intense coordination with NATO neighbor countries. They are expected to play a leading role in the “enhanced forward presence” of NATO and in the rapid reaction forces. Apart from that, the number of international mandates demanding a contribution from Germany is also expected to rise.

All this requires more personnel with better equipment. Germany is trailing behind the NATO investment target of 20% of total budget. According to the recently published mid-term financial planning, Germany will raise the defence budget from this year of €37 billion to €42 billion in 2021. My personal expectation is it will be more than €42 billion.

This leads me to the next page 29 and to the explanation of our assumptions of 2017. Forecasts see global LV production in 2017 growing by about 2%. The largest single market China should slightly exceed this figure. Rheinmetall Automotive is expecting to outperform the market in a moderate growth scenario. We will continue to optimize our assets and cost structures in order to streamline our global footprint.

For Rheinmetall Defence the upcoming years will provide further large-scale business opportunities. As explained the market sentiment is improving and we are confident to benefit from that. As mentioned at other occasions in the past months, we think that 2017 will bring along growth, but to a lower extend than in the previous year, but gain stronger momentum in 2018 and onwards.

The table on page 30 shows the parameters for our 2017 guidance.

In Automotive, we are expecting to grow 3 - 4% above last year's sales. Based on the positive market conditions our expectation for Defence sales will be an increase of 5 - 6%. This translates into a growth forecast of 4-5% on group level.

We maintain on our margin guidance for Automotive of at least 8% or above and increase our margin guidance for Defence to 5 - 5.5%. In 2017, we plan to spend a low double-digit million Euro-figure on our very promising New Technology Initiative. On group level, we are therefore expecting to achieve a margin of around 6.3%.

Ladies and gentlemen, thank you very much for your kind attention. We are now looking forward to take your questions. Thanks.

00:26:30 Operator

Ladies and gentlemen, if you would like to ask a question, please press 9 * on your telephone keypad. In case you wish to cancel your question, press 9 * again. Please press 9 * now to state your question. And the first question comes from Sven Weier from UBS.

00:26:56 Sven Weier

The first question is on the cash flow which has been turning around in the Defence business in 2016 as you highlighted for the first time since 2012. I was just curious on your take on the sustainability of that. I mean given the backlog you have in the Defence business and the margin outlook, what's the confidence of you to keep a positive free cash flow generation for defence?

The second question is just from the outlook you gave for the German Defence pipeline and also some of the projects you mentioned outside of Germany which you already outlined at the CMD in December. Would you say that after three months have passed you're even more confident to turn that into real orders in the next 12 months? Then after also speaking to some of the decision makers.

The fourth question is actually on the auto margin, you said at least stable. I guess some of the headwinds you had last year that's like the decline in the Large-Bore pistons in Brazil. Is it fair to say that this should be no longer a headwind in 2017?

And then last, not least, I think on the Defence guidance you said it's organic growth that you expect. So does it mean that this year we should be expecting you to do some M&A transactions in the Defence business? Thank you.

00:28:17 Helmut Merch

Okay Mr. Weier, I will take two questions first. Your cash flow question; I think you'll remember we have a strategic ratio for both businesses to generate operating free cash flow in the range of 2 up to 4%. And fortunately we meet this target last year, but also you know that in especially in Defence we are heavily dependent on down-payments, but we are quite confident that also for this year we should generate a stable level of free cash flow. And our orientation is this mentioned range of 2 up to 4%.

Coming to your last question regarding Auto margin, yes you're right, we see some slight recovery in the market segments in which we have suffered last year - that is especially Brazil and Large Bore Pistons - I think due to the rising oil price, now fluctuating around USD 55, we see some raising and coming demand from the related industry. And also Brazil, now we are pretty confident that we saw the trough in 2016. Now coming to your margin-related questions we have indicated that we want at least to generate 8%. That is our mid-term target for the segment, but I think we see also potential to go above this 8%.

00:30:11 Armin Papperger

Yes I take over the question concerning the German pipeline and also the international pipeline, and if we are more convinced now. We made the final negotiation for lots of contracts with the German government. So we have about, a little bit more than thirty "25-million-papers" that we have to give to the government. 50% of the paper is Rheinmetall-lead or Rheinmetall is involved. All of these papers are finally negotiated, but as you know we need first of all the approvals from the German government. And these approvals will be in June this year about all these "25-million-papers". To give you an overview where we are, we spoke about the trucks; so we made the proposals for that. We spoke about the Gladius system, we spoke about the ammunition and we spoke about the tank technologies like the Leopard. And all of the work is done, so we have to wait for the final decisions now.

On the international market, some information from Australia. I think the tests that we are doing in Australia are very well. The customer is very happy with our tests and as you know we get the final decision end of this year beginning next year. If we win the contract or the competition with BAE the order intake is expected next year. Now one point is that the Australians said, we want to have phase one and phase two of Land 400 together. Maybe there is a possibility - as you know the first lot on the wheeled vehicle is 2.5 billion - to do it together. So then we would have a bigger chance.

We are very far also in the big vehicle program in Romania. And here is, we are in the final stage also on the negotiations side and we expect also this year a positive decision from the Romanian government. So, yes, we are still very positive and we expect over the next 12 months to 14 months in Germany a very essential order intake.

The organic growth: we have a very strong organic growth over the next five years, but we are always looking for targets. We cannot speak about some targets where we are, but we are looking for them. But I can't say we have no - because it is a question that is already coming from the press - we have at the moment no negotiation with ThyssenKrupp.

00:33:09 Sven Weier

And maybe just one last follow-up question. I think the low double-digit million amount you mentioned to be spent on your technology, is that the central cost? Or are you allocating that to the two divisions?

00:33:23 Helmut Merch

We have different situations. We have made a budget on the holding level but also we have some smaller budgets at the segment level. So in total, we have this low double-digit million volume included in our guidance.

00:33:49 Sven Weier

Okay thank you very much.

00:33:52 Helmut Merch

Welcome.

00:33:52 Armin Papperger

Thank you Mr. Weier.

00:33:56 Operator

The next question comes from Andrew Gollan, Berenberg.

00:34:02 Andrew Gollan

Oh hi, gents. Thank you for taking my question, or two questions please.

First one on margin, kind of aspirations in Defence. Are you standing by your previous comments in medium term targets? I'd say that's around 7%.

Secondly, within the Automotive business, Hardparts in particular, have you seen any loss of market shares? So if we strip out the market effects of Brazil and the Large Bore, can you tell whether there's been any loss of share there? And how does that trend as a business do you feel underlying over the next two or three years?

00:34:45 Armin Papperger

So margin effect Defence, we stay on that numbers. Yes, that is what we stay at. I think we booked in really, really good contracts and we stay on that numbers. And on the Hardparts we lost nothing.

00:35:01 Andrew Gollan

So market share did okay.

00:35:04 Armin Papperger

Yes.

00:35:04 Andrew Gollan

And how do you see the kind of growth, sort of underlying growth, of that business if we look out a couple of years?

00:35:16 Armin Papperger

We have a lot of discussions at the moment with our customers on the Hardparts side. Because we told them that our investments on Hardparts we want to reduce. And they told us what's the reason that you're reducing your investment? I say okay, because we think that the numbers are going down. And the point at the moment is that some of our customers asked us you have to continue for the next years to bring technology into that area because they think that the electromobility, and we think also, cannot grow as fast as some people expect.

And so therefore, we need for the next 10, maybe 20 years also some combustion technology. So we stay on our way, but if there are some customers who would come to us and say, okay we want to give you long-term contracts or frame agreements about that, we have to rethink our investment policy to invest more in electromobility and in Mechatronics. But still we stay on our way what we discussed the last quarters.

00:36:33 Andrew Gollan

Okay thank you. And just one quick follow-up there. You mentioned in the core slide presentation about EV influencing the order book a bit more. Can you just scale what you're seeing now? It seems it's very small still but great potential.

00:36:47 Armin Papperger

It's still small, but as you know we have the first contracts now for the, let me say for the electro engine block, we call it motor block. We have them from OEMs and we have the first contract also for battery housings. But it's still [low] numbers, yes? So and then the total order intake is in the middle double digit millions.

00:37:16 Andrew Gollan

Great. Thanks very much.

00:37:18 Armin Papperger

Thank you.

00:37:21 Operator

The next question comes from Florian Treisch, MainFirst Bank.

00:37:27 Helmut Merch

Hello Mr. Treisch.

00:37:31 Florian Treisch

Hello. You mentioned that you’re expecting some German orders to close in June this year. Are you afraid that you can see some delays here when it comes to current political changes after the change of the head of the SPD, i.e. do you think that the parties are reluctant to approve such deals ahead of the general election in September?

And the second question is around Automotive and a follow-up to the EV question. From my point of view the pumps business is a key part of your EV story. Can you, add some details here, if your first orders and then how OEMs are acting here and what you see as a potential here in the coming years? Thank you.

00:38:17 Armin Papperger

Thank you for your questions. Your first point is that all those contracts that I spoke with you, they are negotiated. So the contracts are ready. But the system is now that the contracts have to go to the parliament; if they are larger than €25 million, then we need the permission. And the expectation is that this 30+ should pass the parliament in June/July. So if they pass the parliament, usually six weeks/eight weeks later, the order intake is there. There are not big obstacles. If the parliament makes a decision for sure, you never know, but the expectation at the moment is yes.

And the reason is also very simple. We have the budget, it’s not an extra budget, we have the budget on Defence ministry level. And the other thing is, there are a lot of programs: If you look to the Gladius for example, that the soldiers really need, because without the Gladius, they cannot fight with the Puma. So it’s a need. And without ammunition, they cannot fight.

And on the truck side is, we have talked of NATO. And even if you change…, if you say the social democrats are going on, we are still at NATO if the social democrats are there. So the pressure will be still high enough. So my personal expectation is it will go.

00:39:59 Helmut Merch

Yes coming to your question regarding pumps. Yes you are right, the pump business is one of the fastest growing businesses. We reached last year a growth rate of nearly 6% and especially the electronic-driven pumps, are also used not only in the combustion engines, but also in the hybrids and the e-cars. So definitely yes we see further growth potential for the pump business.

00:40:32 Florian Treisch

Perfect. Thank you very much.

00:40:33 Helmut Merch

Welcome.

00:40:34 Armin Papperger

Thank you.

00:40:37 Operator

The next question comes from Christian Cohrs, Warburg Research.

00:40:43 Christian Cohrs

Yes hello. Good afternoon. Thanks for taking my question. Maybe first in the Electronics Division in Defence you mentioned that you're facing some problems in Norway, or the Norway subsidiary. Can you maybe disclose or quantify, or at least give us an idea about the amount of losses you face? And how much time and resources does it take to fix the problems? And in light of the fact that the Electronic Solutions business in the past couple of years ago was quite a substantial earnings contributor, do you think that this can reoccur or does this business or does this segment has structurally changed in the meanwhile?

Secondly, on the pension side now with positive free cash flow development in place, do you envisage a further reduction in pension and for the funding of your pensions? Maybe in the course of the refinancing, maybe just by, I don't know, issuing a larger bond in September, and not just replace existing bond, but also do some pension refinancing? And then lastly I missed your answer on the new technology initiative. Will you book this in the holding or will this be spread among the divisions? Thank you.

00:42:08 Helmut Merch

Okay. Starting with the first question regarding our losses in Norway, yes, we faced for the size of the company, some substantial losses. The losses have been in 2016 around €12 million -- same amount we have seen in 2015. We changed management, we changed people, we have now control over the technical solutions. But unfortunately three years ago there were some orders booked which are now burning money. We hope that we can reduce a loss during 2017, but a substantial reduction of losses we expect not before 2018.

So this situation, it lasted a little bit longer than originally expected. But I think coming to your question regarding future development of Electronic Solutions, yes you are right. In former times Electronic Solutions was a division with a stable EBIT contribution and our target is to bring the division back into former situation, and as you already heard from us, the order backlog we had now in Electronic

Solutions is €250 million higher at the end of 16 compared to 2015. And Electronic Solutions, from sales point of view, we expect in 2017 more or less flat. But the push we expect to come in 2018, and with a recovery on the top line in Electronic Solutions, we also expect a further recovery on the EBIT line. So our strategic margin or target for the margin is at least 5 to 6% in this division.

00:44:18 Armin Papperger

Maybe to add one thing. So we changed the strategy in ES now and if you see what we are doing in different areas,… the cooperation with Raytheon is one of the changes. We can't grow more on the Air Defence side and together with system houses like Raytheon we want to do it.

The second cooperation that we have, the joint venture that we bring on the way with Rohde & Schwartz at the moment is with communication systems and battle management systems, helps us also to go into in other areas. And the reason that we're suffering on the ES side at the moment is because we need more orders in different areas. But we were too much in the past on the component level and not on the systems side.

Some people say yes, but systems is a problem, but it's the same what we do on the soldier system. So we combine the soldier system at the moment with the communication and battle management system. And we are doing that on the Gladius side and then we can grow with those areas.

00:45:30 Helmut Merch

Coming back to your last two questions, a) regarding pensions, in Q1 this year we already make an additional funding for our CTA of €30 million. So we will go along with additional funding. I will not exclude that we do some more funding for the CTA, but this is not yet decided. And I think what we are committed to that every year we want to do a certain funding for the CTA to lower the fluctuation risk of our pension liability. But on the other hand I think we saw the trough on the interest rate side and it would not be wise to make a huge funding facing the actual low level of interest because we have also suffered under the actuarial losses in the pension liabilities.

And last questions regarding funding of our new technology initiatives, here I said that we have basically three ways of funding. To some extent we will fund it on holding level, but also to some extent the funding will be directly made in both segments Automotive and Defence.

00:46:49 Christian Cohrs

Okay that's clear. Thank you very much.

00:46:50 Helmut Merch

Welcome.

00:46:55 Operator

The next question comes from Sash Tusa, Agency Partners, London.

00:47:02 Sash Tusa

Thank you very much and good afternoon. I've got two questions. The first is whether you could talk to us about what you believe the quarterly fluctuation in Defence might be in 2017. The last couple of years have been very impressive and quite unusual in that you've started to produce Defence profits quite early in the year. But historically, Defence used to be pretty loss-making sometimes until the end of Q3. And I just wonder whether there's any risk that you go back to that sort of extreme waiting of profits towards the end of the year.

And then the second question I've got is about Turkey where clearly Turkey's relationship with the European NATO countries is deteriorating astonishingly fast. You talked about the joint venture in Turkey, but I wonder if you could say whether there will be a much wider arms embargo associated with Turkey and what impact that might have on you in the current year. Thanks.

00:48:12 Helmut Merch

So coming to the first question Mr. Tusa, I really guess that our normal pattern of the quarterly sales development and where also the quarterly EBIT development is depending on, will remain more or less the same. What we have shown the last couple of years that due to the continuous growth of the top line, we were lucky to reduce for instance the quarterly loss for Q1 or Q2. But on the other hand there's a pattern that we will make roughly 35% up to 38% of total sales in Q4 that we will also predict for the running year and also for the coming years. And therefore we will see this back-end loaded generation of EBIT and cash flow.

00:49:14 Armin Papperger

So your second question about Turkey and at the moment there are a lot of negotiations in Europe between our NATO partner, Turkey, and the rest of the NATO partners. So the impact of Rheinmetall is as you know, we have one joint venture for ammunition, the ammunition is at the moment coming from Germany at the moment where there is no permission for ammunition for Turkey. But there is no negative impact for us in our plan and in our budget because these would be, let me say, very fast need from the Turkish, which is not in our ... it does not impact us.

The second point is that what is going on with the tanks because there a lot of rumors Rheinmetall wants to build tanks. As you know Turkey has Leopard tanks and they lost 10 tanks in fights against IS. And Turkey is asking to make some improvement on the tanks to make a better protection. I've got no final decision from the German government. Yes, if we get permission of export about this active Defence solutions for example, or not, so we have to wait for that.

00:50:35 Sash Tusa

Thank you very much.

00:50:36 Armin Papperger

Thank you.

00:50:40 Operator

The next question comes from Christoph Laskawi, Deutsche Bank.

00:50:46 Christoph Laskawi

Hi, Christoph Laskawi, Deutsche. Thank you for taking my question. The first one would be on Defence. As you already pointed out, even though we might see a changing government, the old sentiment towards more spending should probably remain the same in Germany. My question would be, could a change in government sort of postpone your order intake because the relevant people to sign the contracts for example might change and we just might see one or two months or even three in delay?

The second one would be on Hardparts. You touched on potentially reinvesting. I would like to know how far could you grow your revenues without reinvesting? Or if the current capacity is still good for, let's say, a couple of years seeing steady growth of 2 to 3% going forward. And then on the R&D costs you have on the whole core level. Is that a recurring amount we will see going forward for the next couple years? Or would you probably bring that more into the divisions at a certain point of time when you really see, okay we can allocate this to Automotive or this to Defence more specifically? Thank you.

00:52:14 Armin Papperger

Thank you very much. So your first question is,.. as I told before, all the people on the governmental side and also the people from the financial side expect, because we have a strong need in the programs that everything happens about the programs I discussed before up to September. So I think we will have a decision in July, this is what I think. So we have to wait. I can't give you more transparency. We have to wait. But the signals from Berlin and Bonn are very positive.

The second point on the Hardparts side, no we must not ... we do some investments for that. At the moment, for example, we build up a new piston plant in China. It's not that we are doing no investments, but we can still grow with our factories and we can grow over the next years with our factories.

00:53:17 Helmut Merch

Yes and I think in the recent years we proved that we have a very stable ratio regarding R&D, around 5% of total sales. Within this budget we have some development differently regarding our strategic targets. But the ratio will be stable for the next coming years. And by expecting raising top lines, so the absolute budget for R&D will also raise.

00:53:52 Christoph Laskawi

Okay, thank you. Just on my first question, I wasn't really pointing towards the decision in June/July might be delayed. It was more towards when we have a new government for example, and the ministers could change. Would that cause a delay in discussions? Or do you talk to basically the same people in the army which are in charge of making the purchases?

00:54:20 Armin Papperger

Absolutely. The point is the important people is people, the chief of staff, the chiefs of the different areas if it is navy, air force or army, …there is a need, then there are still the guys who make the budget so from the financial side. So the budget planning is so … usually a new government is not changing totally the budgets over the next years and we speak for sure with all parties there. So at the moment, I see no sign that there is a big delay and that's to say okay there will be a collapse then with the Bundeswehr or so. I cannot see that at the moment.

00:55:03 Christoph Laskawi

Okay very clear. Thank you.

00:55:05 Armin Papperger

Yes.

00:55:09 Operator

The next question comes from Sebastian Growe, Commerzbank.

00:55:14 Sebastian Growe

Yes, two questions from my side and good afternoon, gentlemen. Both on Defence. The first one is on the outlook for 2017. The sales guidance has been €3 to €3.1 billion. Specifically I'm interested in the mix that you have put behind the number. Is it fair to assume that this growth that you expect will be mainly driven by the Vehicle Systems subdivision or do you also forecast higher weapons to ammunition sales given that the order backlog was up €100 million year on year?

Along those lines can you also remind us of what you specifically do see in the ammunitions part of the business?

And then secondly and coming back to the Defence budget question in Germany, and obviously there have been quite so many questions asked already, you, Mr. Papperger, said in your introductory remark however that you expect the final outcome for 2021 to be clearly above the €42 billion that is currently in the plan.

Can you at least share up your best educated guess however I might phrase it, what you would think is the most realistic outcome here? And related to that, would you expect Rheinmetall to above proportionally benefit from any further budget extension based on the discussion that you currently have on the projects behind that? Thank you.

00:56:22 Armin Papperger

Yes. Maybe I start with your second point, because it's very political point. And as you know, the pressure from the NATO and especially also from the US president is very strong. And you see the answers that the German government is giving, and also our chancellor is giving to the president. And they say, okay yes, we want to be more to the 2% than to the 1%. If you see only that, and if you see the GDP of Germany growing up to 20 ... if you calculate it with the figures of 2016, we should spend for Defence as you know €62 billion.

I think it is not possible really to reach 2%. But we will come nearer and this internal discussion is that there is also a need, a yearly need of some extra billions if you see the €42 billion. If it is another €3 billion or another €5 billion, I think it's too early to assume. But there is a need, there is a need because they need the product. So there is a lot of things from the political side, yes which party is going on, and so these are the things for sure. It's not safe because always if you have a new government, yes they can make other decisions.

But the pressure of the NATO, the need of the NATO, and the pressure especially from the United States will be still high, very high above that. So that is my personal opinion that it will be higher than the 42, and it's not only mine. It's in the discussion that I have in Berlin and Bonn about those things. So from the mixture side, we will grow.

00:58:07 Helmut Merch

And when I pick up your question, Mr. Growe, yes your assumption is right. Roughly two thirds of our expected growth for Defence will come from the Vehicle Systems division.

00:58:21 Sebastian Growe

Okay thank you very much for that. And the other part question sort to speak to the budget question I had before, can you just at least over the sum give us an indication what's incremental €100 million or €1 billion, whatever the right magnitude is increase in the budget would mean for you on the basis of the pipeline that you're currently discussing with the people on the ground and the budget guys? Is there any kind of, say, yes, to get least percentage-wise which would be I think reasonable to apply here?

00:58:53 Armin Papperger

Yes, if you see what happens now, if you can calculate it that way, you mean in Germany or what we've … If in Germany, the budget is going up €1 billion. What does it mean for Rheinmetall?

00:59:06 Sebastian Growe

Exactly. Yes.

00:59:07 Armin Papperger

Yes. So if you calculate it, if you make it simple and if you calculate at the moment, so from the investment side I think at the moment it is possible for Rheinmetall to grab if they invest €5 billion, that Rheinmetall can grab about €1.5 billion here from that. So if you calculate this in percentages, so I think it is an easy calculation.

00:59:37 Sebastian Growe

I guess I can manage that. Thank you and finally coming back to the ammunition pipeline, can you just share with us your views and what you see in the market this part of the business is growing further beyond the, I think, you landed at 850, 900 or so in 2016?

00:59:54 Armin Papperger

Yes, we want to stay on the same level now and want to grow then in 18 with the orders that we have. And the point for me is that we have some good order, long-term order intakes and I personally think that with the frame contract that we will get from Germany and we're in the final negotiation about the ammunition frame contract, there is still a big potential for ammunition to grow.

01:00:27 Sebastian Growe

Okay very good. Thank you.

01:00:29 Armin Papperger

Thank you.

01:00:34 Operator

At the moment there seem to be no further questions. Ladies and gentlemen, if you would like to ask a question, please press 9* now.

01:00:49 Armin Papperger

Okay good.

01:00:53 Operator

There are no further questions.

01:00:57 Armin Papperger

Thank you for your time. Thank you very much.

01:00:57 Helmut Merch

Yes thank you very much. Bye-bye.