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Ablauf

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	Präsentation - Beginn	00:00:22	19:52
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1	**Sven Weier, UBS AG**	00:19:45	6:09
2	**Sebastian Growe, Commerzbank**	00:26:03	8:57
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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 Q2 results 2017. At this time all participants have been placed on a listen only mode and the floor will be open for your questions following the presentation. Let me now turn the floor over to your host, Mr. Helmut Merch.

00:00:22 Helmut Merch

Ladies and Gentlemen, welcome to our conference call on the interim results of Rheinmetall Group per June 2017 and thank you all for joining us.

As always I will give a short introduction and then you will have the opportunity to ask your questions.

Before we start I would like to add two remarks. As you know the interim statement is a report, which informs you widely on the figures of the first six months of the business year. With the following presentation slides, I would like to put the focus on the past quarter and this means on Q2. And last but not least, I would like to remind you to take note of the safe harbor statement on the following page.

Let me begin with the highlights of the second quarter on page number 3. After the dynamic start into the business year 2017 with sales growth of above 10% in both segments, the second quarter showed an expected modest growth rate which amounted to 3%.

On the other hand, the earning development of Rheinmetall is still good and the operating result increased by 17%, from €72 million in Q2 2016 to now €84 million in Q2 2017. In addition, I can also report about the positive development of our cash flow.

As we have adjusted our growth target as well as our margin target for Automotive we are able to raise our group guidance for the full year.

Let me also highlight the release of the first Corporate Responsibility Report in May 2017. This comprehensive paper informs about our responsibility for the environment, for employees, and for our stakeholders and our activities to the benefit of our society in general.

As you can read on slide 4, sales normalized in comparison with Q1 and showed a healthy earnings structure. The sales increase of almost 3% of €40 million shifted EBITDA by €11 million or 9% and the operating result by €12 million or 17%. Let me now continue with slide number five.

Operating free cash flow advanced by €94 million to a positive €90 million amount. A detailed breakdown will be provided on the next slide. Earnings per share for the second quarter picked up by 7% from €0.94 to now €1.01 per share. In H1, EPS totaled €1.57 compared to €1.26 in the previous year's period. Headcount slightly rose by 2% and mainly caused by Defence and showed the increased business volume in both segments.

Page number 6 focuses on the breakdown of the quarterly cash flow.

Operating free cash flow saw a strong increase during the quarter by €94 million. As you can see from the bridge, the reduction of our working capital is a key driver and Defence contributed most of that. The explanation behind this development is the increase in customer prepayments. The remaining positions basically balance each other out.

Now to slide 7 with details on the net debt development: We saw a further significant reduction of our net debt position. By now we have taken all necessary steps to refinance the €500 million bond that is coming due in September 2017. Q2 saw a contracted volume of promissory loans in the amount of €122 million of which €107 million were already paid in June. Last year we already arranged a European investment loan of €250 million with the purpose to finance our future Automotive R&D efforts.

Let's turn to the Automotive highlights on page number 8.

First of all, I would like to point out that Automotive had a successful quarter in a rather slow market. Regional market development was diverse and ranged from contracting markets in Europe and NAFTA to rapidly increasing markets in developing regions.

Our sales grew by 4.7% which compares to a global contraction in light vehicle production volumes of minus 0.3%. This market beat was aligned by an improvement of our profitability and cash flow generation, lifting operating margin to 9.2% and increasing the cash flow by €18 million to €69 million.

Now, please follow me to page number 9.

Sales increased by 4.7% to €728 million with all divisions contributing. The currency-adjusted growth rate was at 4.2%. Operating results rose by roughly 12% or €7 million, lifting the sector margin in the second quarter to 9.2%. The key profitability driver was a larger share of high margin products in all divisions. For example, in Mechatronics, solenoid valves for turbo engines enjoyed a very good demand.

Operating free cash flow improved by 35% to now €69 million. Main drivers were the improved earnings and the working capital support. On the following page number 10, I will present you the breakdown of the divisional performance. In Mechatronics the solid demand for our emission reducing products continued and grew sales by 5% to €407 million. Operational earnings advanced by 34% to €47 million, driven by the favorable product mix and higher utilization rates lifting the operational margin to 11.5%.

Hardparts sales increased by 3% to €251 million while results remained on previous year's level and hence reduced the margin slightly by 20 basis points. Positive developments, as the recovery in trucks and Large-bore Pistons were off-set by lower at-equity results from our German joint venture due to additional costs for the ramp-up of new and innovative products.

The at-equity contribution of our Chinese Hardparts joint ventures increased slightly by 3.9% and amounted to €5.6 million in the second quarter. The Aftermarket business rose sales and result at the same rate of 13% bringing results to €9 billion and an operational margin of 9.7%. A recovery of demand in the core European markets was the main driver for this favorable development.

On page 11, you find a comparison of our regional sales with IHS Global Light Vehicle production volume development. As you can see Automotive actually outperformed in every regional market. Especially sales in Asia and South America showed material improvements. In the US, we grew on new Mechatronics products in cars of high demand in a generally contracting market.

Please turn now to page number 12.

Concerning China I can report the following: Let me start with a macro-picture: The second quarter saw the Chinese currency Yuan slightly devaluating against the Euro. Therefore, the growth rates reported in Euro are lower than in local currency. Light vehicle production in the largest car market of the world declined in the second quarter by -1%. Nevertheless, our Chinese entities - the joint ventures and the 100%-owned companies - grew by 10% in local currency. This confirms the high demand for our Automotive products. We were also able to turn this growth into profits. While sales grew by CNY170 million the operating results rose by CNY15 million.

The joint ventures outperformed the market with a growth rate of 7.7% in local currency or 4.4% in Euros. The two Hardparts Joint Ventures contributed by far most of this growth, but we see also a strong growth of our pumps Joint Venture.

Among the Wholly Foreign-Owned Enterprises, I would like to mention the dynamic development of Pierburg China which benefits mainly from the success of small SUVs in the Chinese market. With page number 13, I will now finish the Automotive chapter with a remark on e-mobility and the ongoing discussion about the diesel technology.

In its long history, Rheinmetall Automotive has shown several times that it is able to cope with new challenges. The automobile industry is presently in such a situation and focusing more and more on e-mobility. With products from our existing portfolio, we have already booked orders of around €300 million for battery electric vehicles and around €200 million for hybrid engines. We will contribute for example coolant pumps, engine housings and battery packs.

For the upcoming International Motor Show IAA in Frankfurt, we will present further highlights: an electric traction motor and modular backpacks for batteries of electric vehicles.

On the other hand, I would like to mention that combustion engines still play an important role. Within this technology, we have recently seen a declining market demand for diesel engines in favor of gasoline engines. We have not seen this development in our books yet, as Q1 diesel sales still grew by 8.5%, whereas the Q2 was pretty flat.

With these words, I would like to switch over to our Defence business starting with page number 14.

All key performance indicators show a further positive trend. As highlights of the second quarter, I would regard A, the margin expansion of 70 basis points to now 3.3% and B, the high order intake, which brought us a good step forward on our path to achieve the full year guidance of a book-to-bill ratio of more than 1. On page number 15, I will provide you with the financial overview of the Defence sector.

Defence sales developed in line with our expectation of a pronounced seasonal pattern in 2017, leaving the year back-end loaded with a more or less flat Q2 and Q3 sales. Operating results reported an improvement, lifting the margin to now 3.3%, strongly benefitting from Vehicle System's performance. Q2 reported also one-offs with a net-effect of €-3 million.

We as management decided to resolve the unsatisfying situation at Rheinmetall International Engineering and sold the 50%-stake to our partner Ferrostaal. This negative effect of around €10 million was however fully off-set by the contribution from an unrelated insurance claim.

In the Netherlands, the Boxer order is phasing out in the first half of next year and capacities have to be reduced. Therefore, we saw the necessity to initiate a small restructuring program, which caused expenses of €3 million.

From a cash perspective, Defence saw a very strong quarter with an improvement of €84 million mainly related to working capital reduction, especially prepayments from customers.

On page number 16, you find the details on a divisional level.

Weapon and Ammunition reported an overall slower development, leaving sales at €305 million, €10 million below previous year. Q2 result was impacted by lower sales and a higher share of group-internal supplies at low margins, whereas last year Q2 reported a larger share of high ammunition contracts with external customers. These effects are expected to be completely reversed in the further course of the year, especially in Q4.

The division Electronic Solutions had a weak sales development. Q2 sales declined by 21%, but the results kept level with last year and ended at €-1 million. Again, timing of the order execution and a significantly improved order backlog make us confident that this situation will operationally improve towards the end of this year.

Vehicle Systems more than offset the moderate performance of the first division. Divisional sales improved by €50 million or 17% to now €337 million and the positive leverage propelled results by €13 million to now €14 million or 4.2% operational margin in the second quarter. The good utilization of the Vienna plant due to the ongoing execution of the Australian truck order is here the main driver.

Please join me now to the presentation of the order intake on page number 17.

The second quarter saw the expected order clearance by the budgetary commission of the German Parliament. Only the order for the Gladius soldier system was booked in the second quarter. All other main orders will be booked in the third quarter, but I will come to this in more detail on the following page.

Electronic Solutions acquired more than 60% of the new orders. Besides the Gladius, worth €310 million, the division was able to win two contracts for their Skyguard 3 system, the latest air Defence product with a total volume of €220 million. While the one contract is a follow-up order from an existing customer, the other contract was placed by a new customer. The book-to-bill ratio in H1 was 1.1, so we are on a good track to meet our full year target, a ratio of greater 1.

Please turn now to page number 18.

Obviously, order entry was one of the highlights in the second quarter and here the parliamentary clearance of the major Bundeswehr orders have to be named. Due to the imminent Federal elections, we do not expect any further presentations of Defence proposals to the budget commission before the new Parliament will be fully functional again some time in Q1 next year. All proposals included in the list of various projects do not exceed the threshold level of €25 million and hence do not require Parliamentary approval.

So with the details presented on slide 18 and our internal assumptions regarding the potential order intake of up to €850 million in H2, I think we are on a good way to achieve an order intake of around €1.5 billion net value from our German customer. I would like to conclude my presentation with the outlook 2017 on page number 19.

The overall market development in both sectors looks still positive. In Automotive, we expect a lower growth rate in H2 compared to H1. We are currently not incorporating any adverse effects from the ongoing discussions around the diesel. Bearing this in mind and on the back of the performance in H1, we have decided to raise our guidance for Automotive.

In the light of this new outlook we now expect a growth rate of 6 up to 7% on the top line and a margin level in the range of last year of around 8.4%.

As Defence guidance remains unchanged, the guidance for the group will be adjusted to a sales growth of around 6% and a lifted margin of roughly 6.5%. With this, I would like to thank you very much for your attention and now I am ready to take your questions.

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 the question, press 9* again. So please press 9* now to pose a question.

And the first question comes from Sven Weier from UBS.

00:19:45 Sven Weier

Yes thank you. Good afternoon, Mr. Merch.

Helmut Merch

Good afternoon

Sven Weier

A couple of questions from my side:

The first one, when you said on the Automotive business, you already announced or showed in the presentation two additional products that you will introduce at the auto show. I remember that back at the Capital Markets Day, I think you said that the value of items you have in production is between 100 to 150 content per car and you said that it’s in development would be 200 to 250. So for those two additional products, should we assume that your kind of content per car has already increased since the CMD, the things that you will have in production? That’s the first question.

Helmut Merch

So mainly when I just answer it, Mr. Weier, these two new products are only in the first phase to show our competencies and would serve more or less as a marketing campaign. We have not, up to now, a launching customer. So I would not assume incoming orders in due time. So I would confirm the statement of my colleague, Mr. Binnig during the Capital Markets Day that if we saw a full equipment of an e-vehicle with our components, then we could have a content of up to €150 or up to €200. But I think this is what is our target for mid-term.

Sven Weier

Okay. And the second question would be for Auto on the diesel impact, can you just remind me? I mean this can still go out in various ways, right? To the one hand, the car makers would have to install additional equipment to make the diesel cleaner. Would there be any, I don't know, recirculation product or something that would help to make it cleaner in real conditions? Or is that more of an SCR theme and you don't offer any SCR products of course?

Helmut Merch

I guess our present portfolio would exactly benefit from a further downturn in the diesel production. So I think we are very well prepared to get some benefits out of this possible development

Sven Weier

So you mean if there's more gasoline being sold your content per gasoline is higher than for diesel or how do you mean this?

Helmut Merch

I think we would, we could assume two developments. A, our content per diesel engine would get some positive additional growth. So higher content for our diesel engine and we also see a further increase for the content for a gasoline engine.

Sven Weier

And just on the diesel, what additional products would it be that you would think about here in addition to what you sell already?

Helmut Merch

I would quit the answer for a moment. I will prepare the answer Mr. Weier, yes?

Sven Weier

Okay and then maybe shifting gears to Defence, obviously you've been talking about the pipeline for Germany, and we know there's also obviously lots of things going on internationally, also within Australia. I mean would you be able to provide us with a kind of a range on the book-to-bill in Defence that would see like just above 1 at the minimum and up to, I don't know, 1.2? Would that be possible? Because it's, I think you have been quite precise on what to expect from Germany, but of course there's a lot of other things going on as well.

00:23:57 Helmut Merch

Yes. I have underlined situations in Germany because we guided for a significant portion of order intake during this year, and therefore I tried to highlight that we are on a good way to reach roughly €1.5 billion. You are completely right that we have further order possibilities from abroad.

What we are actually guiding is at least a book-to-bill ratio of 1, 1+ and I guess that we have a good chance also in Q3 to see a comparable number of order intake which we have shown in Q2. But I do not want at this point of time to guide precisely for the full order intake because as you know, customers are sometimes quite complicated [to predict], and I cannot guide you precisely of what we are expecting. We have a great potential and I would assume that in our Q3 call beginning of November, I can provide you a guidance more precise than we do it actually.

Sven Weier

Understood.

Helmut Merch

Yes and coming back to your question regarding diesel engines, I think what we have in our portfolio, is a low pressure EGR system which would benefit from this actual discussion. And I think also having in mind that there are increased technical requirements for high pressure valves, we are well prepared.

Sven Weier

Thank you.

00:25:54 Helmut Merch

Welcome.

Operator

Next question comes from Sebastian Growe from Commerzbank.

00:26:03 Sebastian Growe

Good afternoon, Mr. Merch. Thanks for taking my question. In total it's three, so maybe we can start with Weapons/Ammunition within Defence and could you elaborate a bit on the mix going to the second part of the year? Hopefully you haven't really answered the question implicitly in your introduction remarks, but I joined the call a bit later. But obviously you had obviously not so great mix in my impression, this way in the first half. I guess lower ammunition contributions here. Could you just give us a sort of an idea how Weapon/Ammunitions should play out in the second half?

Then on the Automotive business and here on Mechatronics, pretty much the same story. So I believe that mix was obviously quite beneficial. I believe that also has to do with a good chunk of product coming in from turbo content i.e., solenoid device, etc. Can you just give us an idea what you see in terms of the bookings from customers heading into the second half of the year? And along those lines and along those discussions around the drive train technology of the future, could you give us a sense if there is anything sizable coming along the way when it comes to R&D projects for the second part of the year?

And then last but not least, on Capex one just clarification question I think it was back in 2015 at the Capital Markets Day that you were giving out some Capex ratios for the various segments. And I think if you just take these numbers together you would end up with somewhere between 250 and 300 million Capex for the full year. I'm just curious if you could provide us with the guidance for 17 and in light of the big tickets that you have in the pipeline, especially at Defence in Australia for example. Would you have any idea for us what that could do to Capex in the coming years? Thank you.

Helmut Merch

Okay. So, coming to the first question, Weapon/Ammunition, here I tried to point out that A, in Q2 we had lower sales and I want to remind you that in our Weapon/Ammunition sales we have not only pure ammo sales but also protection sales or weapon sales. And the decrease of the pure ammo sales compared to Q2 2016 was roughly 9%. So it was quite significant and what we have told you that we have also a bunch of group internal supplies at low margins which could not offset the good margin we had in Q2 with a high margin contract with external customers.

What I also said is that this situation will completely reverse in H2 and mainly here in Q4. So we see a seasonal or temporary pattern which affects slightly the Ammunition result in Q2.

Coming to your question regarding Capex, we have guided also during our capital markets day a range in Auto up to 6% in terms of sales and 3 to 4% in Defence. And I would confirm the same ratios for this year. So we will end up with roughly 300 million Capex throughout the full year.

Regarding new technologies, we have guided for extra expenses this year in an amount of roughly 10 million and we have spent in the first half of this year roughly 4 million, so we have a slight acceleration in H2 if all the things will happen as planned.

Regarding Auto, yes you are right, we have a favorable product mix especially in Mechatronics, and I think the trend for turbo-charged cars will increase further. So, especially our business with solenoid valves will have a further growth throughout this year, but also has some good indication for the following years under the basic assumption that the full market for Automotive will be a stable one.

Is it fully covered what you asked? Or did I miss something, Mr. Growe?

Sebastian Growe

Yes just one follow-up on the Capex situation in 2018 and beyond. So clearly if you would win big projects…

Helmut Merch

Ah, yes Australia! Australia will be an interesting issue, so in case we will have the opportunity to get this order, we have obliged ourselves to invest in Australia. And as you know in combination of such big contracts, you have to provide local content and especially this order is combined with a high Australian content. So we are obliged to invest in Australia, also to build up a certain workforce, and therefore there is a significant point of volume of Capex we have to invest.

But on the other hand we also have negotiated with the Federal community in Australia that we also get some subsidies. But I think it is a little bit too early to give you an exact guidance for the necessary Capex. We are now at the final phase of the trials and I think if we have some more flavor in which direction the decision will go, I think then it will be the time to communicate what corresponding figures we see with this contract.

Sebastian Growe

Okay fair enough. And then just really last one, follow-up to the comments you made on Mechatronics and on the solenoid valves for example in particular and the turbo trend. Along those lines, isn’t it fair to assume then that margin is at least not inflated if I may put it this way, but that the very, very strong, almost 11% in the first half, is rather reflective of kind of the market needs for the Mechatronics portfolio currently?

Helmut Merch

Yes, A, I think we have a positive operating leverage that it's quite clear, but also we have new products in place which are covering the high need of the industry of the OEMs. So and therefore we have a situation which is favorable.

Sebastian Growe

Yes, I fully agree with that. Thank you.

00:34:00 Helmut Merch

Welcome.

Operator

Next question comes from Andrew Gollan from Berenberg.

00:34:07 Andrew Gollan

Oh hi gents, thanks for taking my questions, two for me really, one on organic growth and one on Hardparts.

So organic growth just generally, I think in November at Capital Markets Day the markets seemed to get overly concerned I think about the kind of slowing growth trajectory that was discussed at the time in 2017 compared to 2016.

Helmut Merch

You mean, sorry Andrew, you mean in Defence or what?

Andrew Gollan

Just overall.

Helmut Merch

Overall.

Andrew Gollan

The general take-away, the market seemed to get worried about a slow trajectory following a very strong 16. And you guided at the beginning of the year obviously to, I think it was 3 to 3 to 4% growth in revenues. Today you're upgrading that to 6 to 7%.

So my question really was, compared to the discussions and profile that you painted 6/9 months ago at the Capital Markets Day of a slight slowing in 17, and then a pick-up again in 18 based on orders already placed really, do you still see with today's upgrade to the outlook on revenues and growth, do you still see a further acceleration in 18, again kind of based on orders placed already? So that's my first question.

And the second question, coming back to electric and Hardparts, I mean you said obviously in your speech that combustion is still playing an important role and that Rheinmetall is not seeing a slowing demand for diesel products. So firstly, why do you think that's the case? Is it just too early? And secondly what happens when you do and what's your kind of view over the medium term? And I just refer the slight margin contraction in Hardparts, is that a reflection of just a slightly more difficult market going forward? How do you see it all trending?

Helmut Merch

Yes, first coming to the question of further growth, I think what we have to have in mind, Andrew, is in H1 we see also a not as forecasted growth on worldwide light vehicle production of roughly 2.6% and we have outperformed market organically by 8% or roughly 7% FX-adjusted. Now the forecast for H2 is, I think 0.8% or maximum 1%. So with the revision of our order guidance, this means that we expect for H2 for our business a growth rate between 4 to 5%, and this is also once again an outperformance of the expectation for the global market.

I think we definitely would not assume a further acceleration during H2. What could be the situation in 2018? I think we are very well-prepared to meet customers' requirement and demand, especially in our Mechatronics division. So it basically will depend more or less on the development of the overall market. We see some contracting situation in the US. If you look at the figures in July, we also see some declining growth rate in Europe. We see a very modest growth in China, we will expect an overall growth for the full year in China. We see upcoming demand in India, we see some recovery in Brazil and Russia, but the latter is not the market on which we are, or where we expect an over-proportional growth. So I think I'm not able to give you the first guidance for our growth rate for 2018. This I will do in March, but I think we have enough organic growth potential if the overall market development will be a stable one.

Andrew Gollan

Understood, understood.

Helmut Merch

Yes? And coming to Hardparts here, I tried to explain that we see some recovery in some parts of our business, especially Large-bore pistons and also in the truck business. Here we also gained some EBIT momentum which was offset by lower equity results from our German casting joint venture.

Here we saw a situation that we have to ramp up several products, new products and here we have additional ramp-up costs, and if you look deeply in our figures here you'll see that we lost some €3 million out of the equity contribution of the German JV. Therefore we are not unsatisfied with the development in Hardparts and what is very clear that is not our growth driver on the top line and will be not the growth driver for the EBIT development. This is clearly the Mechatronics division and to some extent also the aftermarket business.

Andrew Gollan

Okay that's very clear. Thanks very much.

00:40:11 Helmut Merch

Welcome.

Operator

Next question comes from Sash Tusa from Agency Partners in London.

00:40:18 Sash Tusa

Thank you very much indeed. I've got a couple of questions.

The first is really about the trucks business and the duration of the Australian contract. And one of the things most interesting to me is whether you think you can get a fairly smooth transition from the Australian contracts and into the build-up of the German trucks requirements, or whether there's going to be a gap there.

And then second question, this is slightly a bigger one which it's just about the Electronic Solutions. The division keeps on winning big orders whether for Skyguard or for simulation, and yet the revenues sort of go flattened down. And it's quite hard to understand why it takes so long for that division to turn these seemingly very large public contracts into any sort of revenue growth. I wonder whether you could sort of explain that. Just give us some sort of view as to how that should evolve. Thanks.

Helmut Merch

Yes. Starting with the Electronic Solutions case, here you know that we are not very much satisfied with the recent development over the last three or four years because we saw this flat sales development and also low margin development. But our order book gives us some confidence that from 2018 onwards we also will see some positive growth in this division. And this we tried to explain also during our last Capital Markets Day.

What is the reason? Because it takes a little bit longer than one would normally expect it. To some extent some of the orders have also some development part in the contract, so in order to customize certain systems you need some time in advance to prepare the systems. And therefore you start with only slow or small amounts of sales in the first 12 or 18 months, and then with the fully developed and customized product, you start the real ramp-up of sales.

That is, I think, one very basic explanation and I think this would also be the case from 2018 onwards. So there especially one big order we got last year, an order up to €400 million will start with bigger amounts of sales in 2018. So, therefore our confidence for a growth rate in 2018 for Electronic Solutions.

Coming to your first question, the duration of the Australian truck contract is up to 2020, but we will see the peak of deliveries in 2017 and some declining sales in 2018/2019, and a phasing-out in 2020. We actually are negotiating a follow on contract in Australia which could be placed during the first half of 2018 and this follow-on contract has actually a volume of up to €500 to €600 million. And in case we would get this contract, this would immediately give the follow-on deliveries. But on the other hand, in 2018 we will start the first deliveries for the German contract. So this will be more or less offset the small decline of the Australian contract.

And what is also still in our order books on the contract, the truck contract from Norway and Sweden. And here after a time of R&D phasing, we will start serial delivery from mid of 2018 onwards. So there is a strong flow of sales in the next three years. I think we will have a good capacity utilization throughout the next three years in Vienna.

Sash Tusa

Great. Thank you very much.

00:45:34 Helmut Merch

Welcome.

Operator

Last question for now is from Christoph Laskawi from Deutsche Bank.

00:45:44 Christoph Laskawi

Hi. Chris Laskawi, Deustche. Thank you for taking my question.

The first one would be on Defence and the mixed impact on Weapon and Ammunition. Was that basically…, you already elaborated that this will reverse in the second half of the year. But thinking about probably that being related to strong growth in the Vehicle Systems, we might have sought the parts to, and looking forward, we probably will still see good growth in the division. Can we expect that in upcoming quarters to have an impact which is as notable as this quarter as well in the coming years? Or was this basically a reflection of a couple of things coming together and being extremely negative in this one quarter?

The second question would be on the Hardparts business of the auto side. You already commented that the underlying business in Large-Bore in the US has improved and if we strip out the equity result, the margin came back to 4% roughly. Is that the run rate we should think of in the coming years? Or do you see potential to go back to 5, 5% plus which we've seen in the past?

And lastly on Mechatronics, clearly a very impressive margin that you've shown there with a good product mix, could you comment on the net price downs of the new products that you've launched in the market? Do you actually already see them regarding the ... or considering the fact that the OEMs really need those parts? Or do you currently price them and don't really get any net price down so far? Thank you.

Helmut Merch

Okay starting with your questions regarding Weapon/Ammunition results in Q2, I tried to explain the impact. A, we have a decline of the pure ammo business. Therefore we have an operating leverage effect. And B, we have an unfavorable mix effect and this is not usual, but it could happen because we also have some internal group sales and therefore there is an impact. And I tried to explain that this will fully reverse in the next six months, especially what we see in Q4. So therefore this will be a so-called temporary or one-off effect in Q2. And this should not be the effect for further quarters.

But I cannot exclude that we have also some fluctuation in results and margins in this division. But basically that is still our most profitable division and also for the next couple of years, this will be a sustainable situation.

Second issue regarding Hardparts, I think you are right. The actual run rate in Hardparts margin is around 4%. I will not exclude that we could fluctuate between 4 to 5%, but this will be highly dependent on products and also on utilization rates in different plants. So therefore this is a range which we also have as our target.

Regarding Mechatronics, I think we see some price-downs but I think that is still in the range of normal business and I think if you are in the market with a good product which clearly gives some benefit, some advantage for the customer, then you have also some room for the pricing. But on the other hand in the course of the next couple of quarters, there will be a further price pressure. So I would not recommend to calculate with an 11% margin for Mechatronics for a full year.

Christoph Laskawi

Understood. Thanks a lot.

00:50:45 Helmut Merch

Okay.

Operator

There is another question. It comes from Christian Cohrs from Warburg Research.

00:50:52 Christian Cohrs

Yes good afternoon, thanks for taking my questions. Two actually.

First related to cash flow, your cash flow performance has improved considerably in the first half and now knowing that Q4 is usually the most important quarter to look at in terms of cash flow, can you maybe shed some light on what we should expect with regard to operating cash flow for the full year? So do you think that the part of the benefit achieved in H1 will be washed away in the fourth quarter? Or should we expect also H2 2017 to be above 2016 and so that also full year operating cash flow will be up significantly?

And secondly, what to do with the cash? If I remember correctly, in March when you issued first guidance for the full year, you mentioned an organic revenue growth target for your Defence business which sort of implied that you might have an eye on some M&A targets. So is this a fair assumption? Is this still in place? And or do you want to, yes, or are you simply waiting for some opportunities to pop up?

Helmut Merch

Yes okay, Mr. Cohrs. We are still looking for opportunities not only in Defence but also in Auto. But I think it is not the right timing to comment on such things. If we have to comment something, then we would say something, but anyhow we are prepared to act and regarding cash flow, I think to some extent we saw a nice recovery in our cash flow development already in H1. And we cannot assume that this will be a run rate for the full year. I only want to remember what is our strategic target regarding cash flow ratio for both core protectors, our target is to generate free cash flow between 2 to 4%. And I think Automotive has proven in the last two years to reach this target, and I am quite confident that we will be also in this range this year in Auto.

We have also this target for Defence after seeing some positive development already last year. It is highly dependent as our explanation for Q2 showed, highly dependent also on customer’s prepayments. And therefore it is then totally linked with our expectation for the order intake for this year and then besides order intake, it needs also then the necessary prepayment from customers. So it is hard to predict. So all in all I want to confirm that also for Defence, we want to generate a free cash flow of at least 2% this year.

But also here, if we have a better view for the rest of this year, I can provide you better information, more precise information during our coming Q3 call beginning of November.

Christian Cohrs

Okay. And maybe just some clarification: You also mentioned Auto. In Auto are you keen with regards to new technologies and in Defence are you rather keen on bolt-on acquisitions in existing business fields, or do you want to expand your portfolio?

Helmut Merch

I think basically our M&A strategy has the following orientation. A: we want to have a better market access or we have a better product portfolio. I think that is not very difficult. And if we see also in front of the upcoming situation in Auto, if we see some nice companies which have products which could serve our strategy for the next couple of years and we also are prepared to act in Defence, I think I also elaborated a situation recently in Q1 that is still very difficult to consolidate on European markets because the main targets have a governmental control.

So we are still in the situation to elaborate and to exploit our organic growth and this will be also main strategic direction for the next couple of years. But anyhow, our balance sheet is now strong enough to act and if there is an opportunity, then we will make up our mind.

Christian Cohrs

Okay that’s very clear. Thank you.

00:56:47 Helmut Merch

Welcome.

Operator

If you want to state a question, please press 9* on your telephone keypad. There are no further questions.

Helmut Merch

So then I thank you all for participating in our conference call. Thank you for your questions and have a good day, and see you hopefully at our Capital Markets Day in Q4 this year. Thank you and bye-bye.