Rheinmetall AG
Investor Relations
Conference Call Q2 2019
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 Q2 result 2019. 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 hand the floor over to Mr. Helmut Merch.

[0:00:19] Helmut Merch

Good afternoon, ladies and gentlemen, welcome to our Q2 conference call. I will walk you through the presentation of the slides first and then you will have the opportunity to ask your questions. Please be reminded that during this call, we will make some forward-looking statements, which involve risks and uncertainties as detailed in our disclaimer, which you can see in detail on the following page.

Let's begin with the commercial highlights on page no. 3. The second quarter was in line with our expectations in both segments and we see ourselves on a good way to achieve our full-year targets to which I will elaborate at the end of the presentation. Sales reflected the modest scenario already sketched in May, but our profitability in free cash-flow development went absolutely the right direction. The different market environment development in Automotive and Defense continued. Therefore we will specify our full-year guidance accordingly. Details will be provided at a later stage. Before we dive deep in the financials first, let's have a closer look at some of the highlights of the second quarter on page no. 4.

Automotive confirmed its excellent position as a leading provider of technology in China. The first customer was booked for the serial production of the variable valve train technology and the government of Kunshan recognized our achievements with an award. Defence business signed important framework agreements for ammunition with two European customers and we saw the order intake of the second lot of unprotected trucks from the Bundeswehr. Please turn to page number 5 now.

Operational sales modestly declined by 1.5% with a mild support from FX tailwind to 1.47 billion Euro. Both segments remained below their previous year's sales level. However, operating results showed an improvement of 2.4% to 109 million Euro. Defence overcompensated the decline in Automotive. The special items related to the settlement agreement with the insurance that represented the former board members as laid out in large detail on the 2019 annual general meeting. And also related to some restructuring we did in South Africa. Earnings per share increased by 37% to 1.70 Euro. Three main reasons drove this development: a) Improved operating results, b) Lower minorities especially from our South African company. And a swing in special items from -€8 m last year to plus €6 million this year. Please join me on page no. 6 for the presentation of the operating free cash-flow bridge.

The operating free cash-flow improved strongly in the second quarter from -€140 m last year to now -€79 m, a positive move of €61 m while the decline in depreciation is attributable to last year's non-scheduled write-downs for a vehicle program. Both segments were successful to optimize the working capital with a major share contributed from defence. Please move on to page no. 7.

Net development is in line with the seasonal pattern but remained €42 m below last year's comparable figure. In our equity bridge you can observe the downward adjustment of the actuarial interest rate for the pensions in Germany and Switzerland which lead to decrease of €107 m in other compliance of income. Apart from this normal payout of diligence in the second quarter we already booked a liability as a result of the acquisition of the RMMV shares of €111 m posted against the minority and hence reduced equity. Moving onto the operational analysis starting with the Automotive performance on the following page no. 8.

Second quarter sales in Automotive saw an operational decline of almost 3% and ended at 727 million Euros. If you compare this to the Global LV-market decline of 7.5%, Automotive performed comparably well. Operating margin of 7.3% was in line with our expectations from May and improved slightly versus the first quarter operating margin of 6.9%. Operating free cash-flow recovered by 26 million Euro in Q2 and is year to date on par with last year's figures. The improvement was a result of optimized working capital. Moving now on to page 9.

Mechatronics´ sales declined by 2.4% to 407 million Euros in the second quarter. Lower sales to Diesel engine platforms were the main driver. As already mentioned in the first quarter, the premature discontinuation of a particular engine platform was not compensated and is expected to burden sales until the end of the year. Due to very high order intake in the last two years we started long-term projects to increase the efficiency and lower the emissions of the ICE powertrain that are currently in a very early stage and burdened results. Furthermore the cost allocation of R&D expenses related to E-mobility lowered the operating result as well which was also the case in Q1 2019.

Hardparts reported flat sales in the second quarter, but the operational decline, especially in LV-piston for Diesel light vehicles was compensated by a low margin equipment sale to China, comparable to the one we reported in Q3 2018. Additionally, some operational issues at their Czech production site and a fire at the same site in the foundry department created a further financial burden. Last but not least, Hardparts reported lower at-equity contribution of roughly €1 m.

Aftermarket sales declined by 5.2% in the second quarter. The chief driver behind this development was a low demand in Europe. But the operating result slightly improved to 10 million Euro, lifting the margin to 10.2%.

Let´s switch now to the regional sales development on page 10. The light vehicle market is globally under pressure. Q2 2018 was the last quarter with growth, since then global development has been negative and IHS is now predicting a global decline of -3.7% for 2019. Germany and China both reported double digit drops of LV production in the second quarter, Europe as a whole being very negative, too. Automotive was not able to decouple from this negative market trend, but at least saw a more moderate decline in their global sales. The increase in China was related to the already mentioned equipment sale.

Please move on to page 11. The Chinese market contracted by 16.3% in the second quarter. Again, our Joint ventures and wholly owned foreign enterprises did significantly better. Including a positive portfolio effect, they achieved a growth of slightly above 4%. The portfolio effect included a small transaction with pumps for the local Chinese market. The EBIT decline of €5 m was entirely operationally driven and a result of adverse portfolio effects and ramp-up cost in association with new products. Please move with me to page no. 12.

The decrease of Light Vehicle sales was again driven by the decline of Diesel related sales accounting for a minus of 17.1% or minus 33 million Euros. Gasoline and other Light Vehicle products were only able to compensate half of the effect or roughly 16 million Euros. The continued positive development of the non-Light Vehicle business supported the second quarter and especially our truck business combined with the Large bore pistons contributed almost 7% sales growth. This concludes the presentation of the Automotive highlights and now we start with Defence on page 13.

The second quarter delivered as expected. Stable sales, higher operating result and improved operating free cash flow. Defence is on a good track. According to our radar, we expect a good order inflow in the second half of this year, sales will again be backend loaded and results will continue to improve. We had quite some M&A activity in the first six months in Defence and I will come back to this a bit later in more detail. In the first 6 months these acquisitions have not had any impact on sales and operating result. Please turn to slide 14 for the presentation of the divisional development.

Electronic Solutions and Vehicle Systems were the driving forces and improved sales and operating results in the second quarter. Electronic Solutions grew sales by 2.5% to now 201 million Euros. Based on the accomplished turnaround in Norway and the high order execution, operating result improved even more from

5 to 17 million Euros, yielding a margin of 8.5%. Vehicle Systems achieved sales of roughly 390 million Euros, an increase of 3.7% versus previous year. The operating result moved up by 10 million Euros to now 33 million Euros resulting also in a margin of 8.5%. This development was supported by the good execution in our logistical vehicle business that means trucks and the overall high utilization of our capacities in the division.

Last but not least, Weapon and Ammunition sales fell 16.5% and came in at 207 million Euros. Operating result declined over proportionally and ended the second quarter at 10 million Euros and an operating margin of 4.7%. The main effect came from Rheinmetall Denel Munition, our South African company, who reported a strong sales and profit decrease predominantly related to last year's incident. An additional negative effect resulted from missing German export approvals of around €10 m.

Moving on to page 15 for the details of the order situation. The order entry in the second quarter was relatively modest and accounted for 501 million Euros, a decrease of some 70 million Euros compared to last year. While Weapon & Ammunition was on a comparable level with last year, Electronic Solutions experienced a decline after last year's strong order intake. Vehicle Systems more than doubled the order intake, including the second lot of trucks for Germany. In the six months, Germany ordered 473 million Euros versus 296 million Euros in the previous year period. The big German tickets were the artillery ammunition and the already mentioned trucks. And we expect that our original assumption regarding the German order of around 1.2 billion Euro has a potential to grow up to 1.5 billion Euro. A first package of around 400 million Euros for VJTF and Puma upgrades was already approved and will be booked in July. Or was booked in July, sorry.

Please turn now to page no. 16: After the first two moves with BAE joint venture and the acquisition of the IBD Group, Rheinmetall Defence topped up in Q2 with a strategic re-acquisition of our tactical vehicles, which brought the business back under our full control. In our excellent relationship with Traton we will focus now on the military trucks, where closing is expected for the end of August, so there is no impact on P&L yet. Provectus Robotics Solutions is a small Canadian technology developer. With this acquisition, Rheinmetall expands its robotics and autonomous driving capabilities, which are behind our unmanned ground vehicle and play a vital role for both segments. The deal was already closed in June, but had no impact on the P&L in Q2.

Regarding minorities, RBSL, IBD and RMMV will trigger different effects. The IBD and RMMV transactions will reduce minorities, for example the Chempro minorities disappear completely and RMMV will see a significant reduction of minorities. In the new joint venture with BAE Systems holding 45%, we will of cause share the proceeds of our operations. We expect minorities to be around 30 Eurocent lower in 2019 compared to 2018.

The way we look at the second half of 2019 is based on a number of assumptions, which I would like to share with you. Obviously, the Automotive recovery in the second half of this year will not take place as forecasted in the beginning of this year. IHS has recently revised the full year production growth to minus 3.7%, but we have already seen lower market expectations of up to -5% from other industry participants and we share this view. Therefore we adjust our scenario and expect for our business a development in H2 slightly below H1. The expected ramp-ups will not materialize as planned and will now only account for roughly €50 m compared to the 100 m we expect in May. The automotive margin should therefore remain on the H1 level more or less.

The picture in Defence looks definitely brighter: Our pipeline is fully loaded. We are confident regarding the development of the German orders and expect now an order intake of around €1.5 bn for the full year from Germany. We anticipate again a normal seasonal pattern and expect sales and order entry to be backend loaded. Due to the high operating leverage, we even see some room for a positive guidance adjustment.

After these introductory remarks I would like to take you to our guidance summary on page no. 18. We are confident to achieve a sales growth on group level at the lower end of our original guidance which means a plus of 4%. We maintain the operating margin around 8%. Based on the argumentation on the previous page we revise the sales growth for automotive down to only -3 to -2% and the margin on the level of the first half of 2019 of around 7% coming from originally 8%. Defence is expected to grow sales to the upper level of the original guidance range, that means a plus of 11% and given the already well improved operating margin in the first half of the year, we are positive that Defence will deliver an operating margin of around 9% which exceeds the original guidance level of maximum 8.5%. So therefore thank you for your interest and now the floor is open to take your questions.

00:19:56 Operator

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

00:20:20 Sven Weier

Yes. Hello, Herr Merch. A couple of questions from my side, please. The first one relates to Defense and a somewhat bit more forward looking. Obviously we've seen the backlog for delivery next year, which is a stable 2 billion Euro compared to last year. So I guess on the other hand, obviously you expect this higher single digit, low double digit growth on Defense on average. So is it fair to assume that the orders you get in the coming quarters, that a good share of that will be also for delivery next year so that we should also be able to see a good growth rate in 2020? That's the first question, please.

00:21:04 Helmut Merch

Yes, so actually we are in the running year 2019. Our forward looking guidance to 2020, we will do precisely in March 2020. So I got your questions but it is actually hard to say what will be the right and specified impact. What we are talking about is a long-term growth in Defense and this I want to underline once more. This year we are actually on our good way to run a double digit growth and this could also lead to a single digit growth next year and once more double digit growth in 2021. So on average we will provide and will guide for a continuous growth path but I think it is a little bit too early to give you an exact and precise guidance for sales growth in 2020.

00:22:15 Sven Weier

I mean, that's fair, but I guess if I look at the Bundeswehr order, for example, recent one, is it fair to assume that some of this is also for delivery already in 2020? Or how – ?

00:22:25 Helmut Merch

That is correct and right and we also are actually negotiating a further lot for military trucks and part of this, if we will lucky to get this order, will also be delivered next year. But I think we have three different divisions. There is always some up and downs in negotiations. We want to build up order backlog to ensure a continuous growth path. But we will have some volatility during the next couple of years. That is I think fair to say.

00:23:06 Sven Weier

Good. The second question was just again on your minority. There's obviously quite a bit of a change. So the first question regarding minorities would be if you could just walk us through the bridge between the minus 12 last year and the minus 4 this year. How much of that is South Africa and how much of that is already to the deconsolidation or the – let's call it full consolidation of the minority set that you already have. And how much more is to come from the buy-out of the MAN joint venture?

00:23:38 Helmut Merch

So if you look to last year's figures, the 1.24 to 1.7, so I gave you three indications or three elements, roughly 0,22 Cent is related to the swing of the one-off items last year, €8m minus this year €6m plus. Then we have coming from the operational improvements there is some 3 Cent. And from the minorities, having the situation that we have to book operational losses from South Africa, here we see an impact of roughly €0.19. So from the transactions, we have a positive impact in the second quarter of only €0.02. So the major impact will come in the second half of this year when we do the full consolidation for the mentioned transaction.

00:24:59 Sven Weier

But what is – I mean, what is the minority charge and the P&L related to that joint venture? What was it last year? So what's the absolute euro amount that related to that? Then we could put it into perspective of the purchase price there now.

00:25:15 Helmut Merch

Sorry, what do you really want?

00:25:18 Sven Weier

You bought out the joint venture but it was not effective in Q2 yet, right?

00:25:23 Helmut Merch

Exactly.

00:25:23 Sven Weier

And I think the purchase price was around €111m. And I was just wondering what the absolute reduction in the minority result will be as a consequence?

00:25:34 Helmut Merch

For the second half of this year?

00:25:35 Sven Weier

No, for – on an annualized basis.

00:25:38 Helmut Merch

Yes, the annualized basis will be around €0.30 plus.

00:25:45 Sven Weier

And that is just for this transaction, yes?

00:25:49 Helmut Merch

Yes.

00:25:51 Sven Weier

Okay. Understood. Good. And I was just maybe lastly wondering on the Auto guidance. Obviously in Q3, Q4 you have tougher comps than in the first half but yet the reduction in the sales is not higher than you had it in the first half. So is all of that just also still coming back to the product ramp-ups you have, that kind of assures that?

00:26:20 Helmut Merch

Yes, that is the one element. I think we were forced to reduce our expectation for further ramp-ups from €100m, as you remember I made the statement in the Q1 call. And now we have seen a lot of delays in customers' demands and expectations and therefore we are forced to reduce this effect to roughly €50m. As you know, we do not have a glass ball on the desk. So actually the IHS forecast is minus 3.7% for the full year and this would imply a reduction for H2 versus H2 2018 only for 1%.

I think we will share the existing expectations of up to minus 5% and this would imply a reduction in H2 2019 versus H2 2018 of roughly 3.5%. So also we expect a reduction or decline in H2 versus H1 and given the fact that we were able to outperform on an FX adjusted basis, global vehicle production by roughly 270 basis points, we had some corresponding expectations also to this figure. So therefore we came out with our estimation which is around minus 2 up to minus 3.

00:28:05 Sven Weier

And is your guidance for the second half including further equipment sales to China? Because that was a positive impact.

00:28:08 Helmut Merch

No. That is normal business but will not take place every quarter.

00:28:18 Sven Weier

And are you assuming a slow-down in trucks for the end of the year? Given that this market has been quite weak.

00:28:26 Helmut Merch

I think a little bit, but no comparison to light vehicle production. I think in Q2, truck business was pretty stable as you have seen, but I think that it's a little bit related to the overall economic climate. We will see a slight decline.

00:28:48 Sven Weier

Okay. Thank you, Mr. Merch.

00:28:08 Helmut Merch

Thank you for your question, Mr. Weier.

00:28:54 Operator

The next question comes from Sash Tusa, Agency Partners. Please go ahead with your question.

00:29:00 Sash Tusa

Thank you. I've got two questions. The first is just could you confirm that the total cash costs of acquisitions probably for the whole of the second half but largely in

Q3 will be around €140m? i.e. the €111m for IBD and RMMV and then the extra €30m or so for BAE Systems' share of the land business?

00:29:33 Helmut Merch

Yes, more or less you have done the right calculation, but my figure's slightly higher. So the total amount for all acquisitions reach a figure of roughly €180m, €111m for the re-acquisition of RMMV share, roughly €36m for IBD and buy-back from minorities and €31m for the share of BA Land Systems and €2m for the small Canadian. So we end up by roughly €180m.

00:30:16 Sash Tusa

Great. And all of that should be done by the end of the year? But should we assume most of that in Q3?

00:30:23 Helmut Merch

Exactly.

00:3025 Sash Tusa

Okay, thank you.

00:30:25 Helmut Merch

We have already seen some cash out in Q2 but the major cash out of over €100m we will see in the beginning of Q3.

00:30:00 Sash Tusa

Okay. Great, thank you. And then the other question is really just to confirm the trajectory of your Norwegian business. It's clearly terribly good news that you feel you finally turned that around. I'd just like sort of some comfort that you think that can stay comfortably in the black rather than sort of dropping back down into loss? Because clearly it's been a very difficult business you've turned around in the last couple of years.

00:31:00 Helmut Merch

Yes, exactly. So this was a major driver of Q2 improvements, especially for ES. But I think what we have done so far, we reduced the complete size of the total business. We have concentrated the business only on one side. We originally had three sides; we now have only one side. We reduced the labor force by roughly 30% and we have now focused the business model of only some few products. So basically we should have seen the trough, now we see the turnaround. I think we can stabilize a whole business on a low level.

00:32:00 Sash Tusa

Super. That's very good news. Thank you very much.

00:32:05 Helmut Merch

Welcome. Thank you for questions.

00:32:08 Operator

The next question comes from Christoph Laskawi, Deutsche Bank. Please go ahead with your questions.

00:32:14 Christoph Laskawi

Hi, thanks for taking my question. Also somewhat related to the Norwegian business and the very strong performance that we've seen in Electronic Solutions. Given that you are now guiding for 9% for the full year and it's already the upper end of your mid-term target, this assumes I guess that the stabilization is sustainable and also in vehicles systems, we probably see an improvement going forward with the improved utilization. So could it be that you overshoot the mid-term target in the coming years? Or are there several negative impacts to come that we need to consider?

00:33:01 Helmut Merch

I think – actually you are right. We are touching the upper band of our mid-term guidance and we are lucky about this development which is based on several positive improvements. I think it is a little bit too early to revise our mid-term guidance, which we laid out in March. I think we will focus on improvement of our business and we will also focus on stabilization of a very good margin development.

So I beg for understanding that first, we have to and to deliver year end results in the next couple of months. Actually we do our planning for the next three years' period and in March next year we will provide the financial community with our guidance for 2020. And in case we have strong signals that we are able to have also new insights for a mid-term guidance, we will be happy to give you accordingly some information.

00:34:27 Christoph Laskawi

Thank you. And another one on Defence on Weapon and Ammunition which was weaker in Q2 due to several factors. Do you expect that to reverse again in the second half? I guess that's sort of implied in your guidance. But should we already expect a snap back in Q3? Or is it really all Q4?

00:34:47 Helmut Merch

Yes. I think we have some negative impact from South Africa. We gave some indication last year when we informed you about this incident. Now we are pretty sure that we can start new production during Q3. So a slight recovery also from South Africa we will expect during H2. We also see more or less flat sales in Q3 in Weapon and Ammunition. So once again a back end loaded situation in Weapon and Ammunition with strong growth in Q4 compared to Q4 2018.

00:35:37 Christoph Laskawi

Thank you. On Autos and the lowered expectations for the call-offs, is that related to rather one or two projects? Or is it really broad-based that call-offs has come below expectations?

00:35:50 Helmut Merch

It is broadly based. What you actually see, we were clearly hurt in Q2 and also in Q1 by the diesel reduction, so we lost some 15% looking especially to our diesel sales. So this is only partly recovered by some ramp-ups with gasoline products but more or less it is a broadly wide-based situation coming from more or less all regions, all customers and more or less all products.

00:36:32 Christoph Laskawi

And is part of that also pricing in that division? Because we heard – all the OEMs making their rounds, calling up the suppliers, asking for further reductions ahead of usual price pressure that you see anyway?

00:36:47 Helmut Merch

Yes. You are right. We see a specific part in our business in which we have a good market position: that are the solenoid valves. Here we have a leading market position. And having seen this we got some new competition which enables the OEMs, putting more price pressure on our product, yes, in this specific situation we see higher price pressure. The normal price pressure, as you know, is always in the market, but here we see some – yes, some more product-related price pressure according to our very good market position in the last couple of years.

00:37:47 Christoph Laskawi

Thank you. And the last question from me, I promise, on working capital in Autos it already was a decent swing-back in Q2 and the question would be if the situation that you are seeing which is being shipped from one country to another and hence weighing on your working capital overall, is that the situation resolved? Or should we expect another swing-back in Q3 as well?

00:38:16 Helmut Merch

I think the issue we flagged out in Q1 or also during our year's end conference, this is more or less solved. We cannot exclude a similar situation but we are not in the position to give a precise prediction, but for the normal part of the business I think this issue is off the table.

00:38:42 Christoph Laskawi

Excellent. Thanks a lot.

00:38:45 Helmut Merch

Thanks, Mr. Laskawi, for your questions.

00:38:48 Operator

The next question comes from Christian Cohrs, Warburg Research. Please go ahead with your question.

00:38:54 Christian Cohrs

Yes, good afternoon, thanks for taking my questions. I will ask them one by one. May we first come in back on the Defence margin. I will try it in a different way. You now already are eyeing your mid-term target of 9% to be reached this year. Are you simply faster in tapping the potential of the divisional profitability scope? Or are you actually better, or have you figured out more potential to improve profitability? That's question number one.

00:39:30 Helmut Merch

Yes. I think that it's a very good question and I want to answer this question as follows. As you know, our business is not comparable to mass production like we have in Automotive. We have long-term projects which have chances and risks and you remember a little bit last year's discussion in Q2. There we have some finalization on projects and with every big project you'll put some buffer in to cover potential risks from execution, from delays, from further claims from customers and so on. And I think we now are managing a lot of projects and there are always some projects executing a little bit better, some a little bit worse. It depends from the project portfolio.

Now we see in this year that we have a good execution. We trimmed our project management skills but also we have learned a little bit more to make claim management towards our customers. So it is a lot of different small elements which have now led to our confidence to reach the upper band or to over-achieve a little bit the upper band of our margin guidance, Mr. Cohrs.

00:41:17 Christian Cohrs

Okay. Okay. Then maybe second question, Vehicle Systems, looking on Q2 on a standalone basis, you have achieved €40m incremental sales year-over-year and this translated in €10m incremental EBIT. Is this simply operational gearing? Is this efficiency? Pricing? Or do you think a quarterly evaluation of this type is misleading?

00:41:43 Helmut Merch

We have a normal operating leverage, and if you have the factories fully loaded, you have higher operating leverage. This is one effect. But also here we have on a quarterly basis we did our project reviews and if we have the chance to release some of our buffer of the risks, we originally have calculated then we are able to release it during a quarterly review. And therefore it is once again a mixture of different elements.

00:42:37 Christian Cohrs

Okay. Okay, understood. This may be also, touches maybe already the next question. The net result of other income and expenses in Q2 2019 looks quite favorable in a year-over-year context and at the same time I think you realized €42m in provisions year-over-year. So can you shed some light on this issue? Did you have lower warranties etc due to successful project execution? Or what’s the background here?

00:43:01 Helmut Merch

You mean the overall Group results, yes?

00:43:04 Christian Cohrs

Yes. Yes, now I'm on a Group level.

00:43:06 Helmut Merch

Yes, yes. Compared to last year's development, we have a lower level of provisions regarding warranties and this is one major effect.

00:43:22 Christian Cohrs

Okay. Okay, understood. And then just two questions for clarification. First, you said, if I'm not mistaken, regarding RMMV. You expect on an annualized basis €0.30. I assume you meant the EPS level. So is it fair then, multiplied with 43m shares that you mean in absolutely the model of €13m? The impact on the minority side?

00:43:50 Helmut Merch

Yes. Yes. You're right.

00:43:53 Christian Cohrs

Okay. And you said annualized? Am I mistaken, not mistaken, that this buy-out will be retrospectively applied, as of January 1?

00:44:05 Helmut Merch

No, we have to look at the IFRS standards and here the retrospective calculation is not allowed. So we have this for the second half of this year.

00:44:25 Christian Cohrs

Okay. So the full impact will then materialize in 2020?

00:44:31 Helmut Merch

Yes.

00:44:32 Christian Cohrs

Okay. Okay, understood. And then also sticking to minorities, do you expect now that your South African operations P&L will be fully up and running, also back to the old financial performance in 2020? Or do you think the ramp-up with the new factory will take longer?

00:44:52 Helmut Merch

I think this question is also fair and good question, but I cannot answer this question at this early stage. We have to look what will be the start in Q3 for recovery and then we have to look to this recovery, how it will run. And I think from today's point of view I will not be able to give a good and wise answer to this question. We have to wait further three or four months, then we are in a better situation to give a better judgement what this operation look like.

00:45:44 Christian Cohrs

Okay, that's fair. And then the very last question. In the presentation your outlook and the footnote, it still says it's assuming no hard Brexit. Now this scenario might not materialize. So Automotive is I think quite clear, what a hard Brexit could actually mean, but with regards to Defense now with the BAE, you're also increasing your UK footprint and the Boxer contract could come on top. So what are actually your hard Brexit fears that you explicitly mention it in the footnote of your outlook statement?

00:46:24 Helmut Merch

Yes. I think with the move to overtake the 55% of the business in UK from BAE, we are well prepared to respond to the demand and need of the British MoD. I think if we will see a hard Brexit, then we will probably see some turmoil. But actually after a couple of months they're coming back to normal business. So we do not expect a real negative impact. The move was also to respond to this possible political turmoil. So I think we are well prepared.

What we are more focusing on is what will happen to the German OEM situation. We actually see that the export volume of German OEMs to UK is already depressed and I will not exclude that if there is a hard Brexit and there are some barriers regarding tariffs and so on and some operational issues regarding handling of the import and export issues, then there could be an additional negative impact. And this is our hidden fear, but we cannot give a price tag on this. So it is a normal disclaimer, because nobody is able to predict the very results of a hard Brexit. Everybody is now better prepared than 12 months ago, that is very clear. But there are still some uncertainties and we do not oversee them.

00:48:25 Christian Cohrs

Okay. Thank you very much.

00:48:28 Helmut Merch

Thank you, Mr. Cohrs, for your questions.

00:48:32 Operator

The next question comes from Sebastian Growe, Commerzbank. Please go ahead with your question.

00:48:37 Sebastian Growe

Yes, good afternoon, everybody. Mr. Merch, one question on Auto to start with, on Mechatronics. You I think also highlighted obviously that you had some R&D cost, I think also sizeable R&D costs related to combustion engine efficiency improvement, e-mobility, etc. Can you just give us an idea to what extent that burden be overall EBIT line Mechatronics in Quarter 2, eventually also then H1 and for how long is this likely to continue? Because you talk about the long-term nature of those spendings.

00:49:08 Helmut Merch

Yes. I give you some flavor. We have – and this is not a figure we have reported so far because the figure of order intake in Automotive has some different content compared to Defense because here we are only looking to long lifecycle contracts, and these contracts have a certain volatility.

But to make it clear, we had extremely high order intake, especially Mechatronics, in 2017 and 2018, over €2b and more and therefore we were obliged last year to hire additional engineering staff to put R&D work in those kind of contracts. And normally you are able to cover those additional costs by growth. Now we are in a situation that we have to work on these products which give us confidence for future growth in the next couple of years and we have to cope with these challenges.

And now we have the onboarding of additional engineering people and this gives us a financial burden which is now popping up. And to give you a flavor in Q2, this financial burden was around €4m and I think we have to cope with this figure also for the next couple of quarters. We are still a believer of the future growth in the order business and we were lucky to book all these contracts so therefore we were obliged to make this additional staffing and now we have the situation we have some R&D costs related to the future but not enough growth to cover this cost. That is a simple answer to the right question.

00:51:31 Sebastian Growe

No, it's very helpful. The other point and question related to it is obviously when is growth coming back? And you referred obviously to the start of production at about 50m and the second half of the year, if I heard that correctly, is it fair to say that Mechatronics overall on full-year basis might be at least getting close to the prior year level of €1.657m?

00:51:54 Helmut Merch

No. No. I think we will see both divisions or all three divisions will see some lower top line development but I think if we all believe in the recovery of Automotive figures, then we clearly see the driving force of future growth within our Mechatronics division.

00:52:27 Sebastian Growe

Okay, that's clear. And then, because you just talked about potential recovery on the market and in particular we heard yesterday Osram saying that they see some signs of stabilization at least in China, if not a sequential increase, interestingly. Well, it's early days but nonetheless, can you just give us some of your observations in China in particular, if any?

00:52:46 Helmut Merch

So we do not see this signal in China. We do not see some positive reaction to the VAT reduction we have seen in the first half of this year. So China will be tough and I personally see also that Q3 will be a challenging quarter and therefore we cannot share this positive or optimistic view of some of the other market participants.

00:53:28 Sebastian Growe

Okay, that's fine. Then moving on to Defense and I promise it's another two questions, then I'll let you go.

It's on the eco-systems. Maybe sort of a related question to what we discussed earlier, but there's a higher level question from my end is we have seen very strong operating leverage in the last couple of years. We have seen very strong top line growth obviously. The question that I do have is what's the utilization currently like and the recent acquisitions you made and also for instance the BAE joint venture. Would that help to simply give you some additional leeway and until when can you really ride this wave before you would have to increase CapEx spend and eventually relay the ramp-up cost?

00:54:17 Helmut Merch

So one or two questions. I think actually in our truck business we are completely full and we are running at a level of roughly €700m and we cannot drive this line furthermore without any additional CapEx. But I personally see for the next two years no further top line increase in our truck business. We see more top line increase in the tactical business and therefore I think it was wise to buy back the share out of the RMMV joint venture. That is one answer.

The second answer is as you are aware we actually are building a new plant in Australia for the Land 400 program. We are actually bidding for the second phase for Land 400 and if we would be lucky to get this order also a big portion of additional sales will be produced, manufactured in Australia. A lot of the potential sales of the expected Boxer contract out of UK and also out of the Challenger upgrades program will be produced in UK, especially in the Telford plant and therefore we have now a good position. We have a production site where we are not obliged to spend CapEx. That is the second answer.

And the third answer regarding Australia is here we got a lot of governmental subsidies which gives us not the full burden for additional CapEx. I think we have to invest in IT. We have to invest in people, that is by far the most challenging situation to get the right people to the right project in the right time. So we will see and this we have already guided in last year's capital market day, we will see CapEx peak in 2020. But from then on we will see some slight decrease and ratio wise we will be stable on Group level on a level of around 5%, maximum 5.5%.

00:57:12 Sebastian Growe

Okay, very clear. And if I may just summarize it in my own words. It would be fair to assume that logistical operating leverage effect that we have seen over the last couple of years is kind of coming to an end but it's still, I think, operating at good margins on good utilization from the backlog and it's now simply moving on, so to speak, to tactical? Is that the right way of looking at it?

00:57:34 Helmut Merch

That's one of the best summaries I have heard of.

00:57:37 Sebastian Growe

Thank you so much. But that would also mean then that obviously operating leverage is not coming to an end, it's going to continue but just really on the technical side of things, right?

00:57:46 Helmut Merch

Yes.

00:57:47 Sebastian Growe

Okay, very good. And the very last question really on the guidance again. 2019 compared to 2018 and the second half of 2018 we had obviously very strong mix, particularly in the Quarter 4. Is there anything worth mentioning when it comes to any mix consideration for the year 2019 which might then look really very different to what we did see last year?

00:58:10 Helmut Merch

I think what we actually see, we have this normal seasonal pattern that we have a very strong back-end loaded situation. And if we look especially to Defense, then we expect for Q3 a sales number of roughly 800m euro which is roughly €100m more than Q3 2019. But the real push we expect in Q4 is roughly €1.4b and this is a plus of €200m versus last year and therefore you can imagine that we are expecting a nice operating leverage. We have or were forced to build also some fixed costs up, but on the other hand we see this double digit growth and I think we have some good leverage to be seen in the various projects and various divisions, so this is more or less our forward guidance.

00:59:27 Sebastian Growe

Okay. Very, very helpful. And, sorry, one very last thought that came to my mind and definitely that's the very last question now. On the mid-term targets and then looking at things a bit differently. We have been discussing the Mechatronics situation, that the OEMs would allow eventually to earn a margin X and then they eventually would simply try and negotiate a bit harder. Is there any similar pattern that one should be aware of eventually also for the Defense part of the business?

00:59:59 Helmut Merch

Now I have to take a deep breath. That is a nice question, but it is hard to answer. I think what we are actually experiencing is a good market condition and I think we are able to respond with a very broad and modern portfolio. So I think it depends on every customer, on every contract we are dealing with. So I cannot give a right answer to this question, Mr. Growe.

01:00:36 Sebastian Growe

That's okay.

01:00:38 Helmut Merch

It's probably too early.

01:00:39 Sebastian Growe

All right. Thank you so much.

01:00:41 Helmut Merch

Okay. Thank you for your questions.

01:00:46 Operator

The next question comes from Sven Weier, UBS. Please go ahead with your question.

01:00:51 Sven Weier

Yes, hi again. Sorry, also a couple of quick follow-ups. The first one is just maybe you could give us an update on KMW and KNDS and anything that has changed. And obviously we've seen a bit of a push from the German government for the French to go forward. But are you sensing any difference to May or is it completely unchanged?

01:01:17 Helmut Merch

That is actually completely unchanged, especially what you are interested in. I think actually what is the situation? The governments and the industry parties, that means KMW, Nexter and Rheinmetall, are presently discussing and working out an industrialization concept around MGCS. And here there is a deep dive in the segmental work packages and so on. But the big question, who is running what, who is responsible for, and what are the pre-conditions on the industrial side, what are the pre-conditions on the governmental side, these questions are not yet solved.

01:02:11 Sven Weier

Okay. Good. Yes, not so good. Let's see then on Brexit, right? I mean, obviously we had that question but I was just wondering, I mean, the slightly above €4b order intake that you see for the year, I guess is including some UK projects, as we know. And I was just wondering, obviously there's also been a change at the helm of the MoD. And what's your sense as regarding the impact? I mean, what are your people on the ground saying? How's it moving forward? I mean, obviously you've repeated the guidance so you must be very confident despite the change at the helm?

01:02:50 Helmut Merch

Yes. So what we heard from our partners on the other side, that they are still very keen to go forward with the negotiations. As you know, the Boxer program is being negotiated between the UK MoD and the European OCCAR and OCCAR is then obliged to negotiate with ARTEC. ARTEC is the joint venture between Rheinmetall and KMW in which we have this 64% stake. So from the military side everybody is willing to go forward and to sign. So given the fact that we made this, I think, smart move to join forces with BAE, but having the lead in the country or within the programs, we are well prepared and they have the need to modernize, they have the need to invest in armored transportation capacity. So I only see a potential slippage, but not a complete delay or complete cancellation. Thanks.

01:04:28 Sven Weier

But both projects are in the 4b or just one of them?

01:04:31 Helmut Merch

No. Then I would raise a much higher number. The Boxer program is in a range of 1b euro up to €1.2b and the Challenger upgrade is in the volume of €700m up to €800m. So there is a complete volume of roughly €2b from UK.

01:05:03 Sven Weier

But just half of it in –

01:05:05 Helmut Merch

Pardon?

01:05:10 Sven Weier

It's just half of it in the €4b? Is that fair?

01:05:17 Helmut Merch

That is not a fair question.

01:05:21 Sven Weier

Okay. And then, sorry, lastly on the – you mentioned the fire impact in the Czech Republic, on the Autos business. So is it fair to assume that this had kind of a low single digit million impact on your earnings? And I was just wondering, is this impact now sorted? So are you back to normal in Q3?

01:05:40 Helmut Merch

Yes. So fire is out. Fire is out and production is running and this was only an impact in Q2. But on the other hand I also flagged some operational and quality issues. Here we have to work on these kind of issues the next couple of quarters. So these are not easy tasks and here we also expect some financial burden in H2. But regarding the fire incident, here we had some impact of €1m or €1.5m in Q2.

01:06:23 Sven Weier

Okay. That's it from my side. Thanks again.

01:06:27 Helmut Merch

Thanks, Mr. Weier, for your follow-up questions.

01:06:33 Operator

At the moment there are no further questions. If you would like to ask a question, please press 9 and star now. Mr. Merch, there are no further questions from the audience.

01:06:48 Helmut Merch

So then I want to make some closing remarks. Ladies and gentlemen, we have seen that Automotive is keeping up relatively well in this difficult market environment and I think we can state that we are pulling the right strings to increase the resilience of the business and to prepare for the challenges lying ahead. Our Defence segment has a solid prospect for further profitable growth. Not only do we grow at a high pace and improve our profitability, we also see the necessary order intake to substantiate our future development.

Before I close the call, please allow me a personal note. After 19 years of service with Rheinmetall AG, Franz-Bernd Reich, our current Head of Investor Relations, will end his career and start to enjoy is retirement. Mr. Reich started investor relations work at Rheinmetall and virtually seen it all from IPO to spin-off, all the ups and downs of the cycle in those segments. I would like to thank him very much for his contribution to today's reputation of our financial communication and wish him all the very best for the hopefully many years to come. Dirk Winkels who has joined the company in 2016 and had the chance to prepare for this role will succeed Mr. Reich in his responsibility effective as of today. Mr. Reich, again, thank you very much, and all the best from the entire team.

With these remarks I would like to end the call and thank you very much for joining. Looking forward to see some of you during the Q3 roadshow activities. Have a nice day, and bye-bye.