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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 Q2 results 2021. 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 Helmut Merch.

[0:00:25] Helmut Merch

Thank you for your kind introduction.

Ladies and Gentlemen, Welcome to our Q2 2021 earnings call. I hope you are all well and safe. I will start with the presentation and will then be available for your questions. As usual, please be reminded of our legal disclaimer on the following page. Furthermore, I would like to remind you that the presentation reflects the numbers of the continued operations unless stated otherwise. Let me now start with the group highlights on page 3.

Concerns that defence budgets would be subject to cost-cutting measures were calmed down. All our home markets recently raised their defense budgets for 2022.

The expected market recovery has occurred, but was held back in some business areas due to growing supply worries, like for example for semi-conductors. Rheinmetall delivered the targeted double digit growth and generated sales of around EUR1.3b. Group margins ended at the upper range of our quarterly trading update and reached 8.1%. Operating free cash flow significantly improved by EUR220m to plus EUR15m and last but not least our earnings per share showed a convincing improvement. Finally, joining the UN Global Compact is a clear statement of commitment towards the sustainable development of our company.

We are now reporting the piston business as discontinued business in accordance with IFRS 5. We were obliged to book another value adjustment due to the recent market deterioration, but I will explain this at a later stage in more detail. The disposal process has progressed to the next stage, but is now facing some COVID related delays, due to the fact that travel restrictions still apply for some countries. Let‘s turn to the Q2 highlights on page 4.

The recent market environment clearly increased pressure on the piston business setting basically an end to the business model in Europe by 2035. Parties invited to submit a binding bid reflected this development in the purchase price indication that we receive recently. Consequently, we saw the necessity to impair the assets of the related business. However, the impairment has no cash impact and is completely separate from the core business. It has absolutely no impact on our group guidance and shows only in the reporting line earnings after tax. Let's continue on page 5.

Our tracked vehicles generated excellent news flow over the last weeks. The long announced Puma retrofit contract finally received budget approval and ends the discussion about a potential termination of the upgrade. Due to speedy signing procedures the contract was already included in the Q2 order intake.

The German Kodiak order for example is extremely important, because it underpins our competence for supporting vehicles. The challenger order was finally signed in May and the preparations for the upgrade have already started.

The most recent announcement was the down-selection for the digital study of the Bradley replacement project, clearly one of our future highlights, however order entry will be booked in Q3. Please move on to page 6.

Sales rose operationally by 13.2% to around EUR1.3b. Q2 20 was the most COVID-affected quarter and we are now observing the recovery, especially of the automotive related markets. The volume increase and the continued group-wide cost discipline were strong pillars for the significant improvement of the operating result from EUR55 to EUR106m lifting the margin to 8.1%. I would like to point out that the aggregated first half results of EUR191m were the best first half results ever for Rheinmetall!

The Q2 EPS performance for our continued business showed a material improvement from minus EUR0.09 last year to EUR1.45 in Q2 2021. Please continue on page 7.

The operating free cash flow only shows the continued business excluding pistons. Q2 reported a very strong recovery of the operating free cash flow from minus EUR210m to positive EUR15m. The recovery was based on two strong pillars: obviously the improved earnings situation across all divisions, but as well the favorable working capital performance compared to last year.

CAPEX is expected to remain slightly below 6% in the full year after 5.4% in 2020 with spending more geared into the second half of the year. Please turn to page 8.

Our balance sheet is still rock solid and the equity ratio of 29.4% further improved compared to year's end 2020. In addition to the earnings improvement, we saw for the first time an increase of the discount factor for our pension provisions resulting from 0.68% to 1.11% in Germany and from 0.14% to 0.26% in Switzerland. This finally resulted in total reduction of the pension provision of EUR80m compared to the end of last year. Our net financial position has significantly improved from minus EUR593m to now minus EUR183m. Please move now to page 9.

We are very proud to announce that the order backlog in vehicle systems has crossed the EUR10b mark driven by the excellent Q2 order intake of EUR1.8b. Key contributors were the orders for Challenger, Puma and Kodiak for the UK and Germany, as already mentioned.

Q2 sales of 461 million Euro were slightly increased compared to last year. However, the operating result slowed to EUR40m because of a less favorable sales mix.

The operating free cash flow rose sharply by EUR155m to a positive EUR96m, mostly driven by milestone payments. Please turn to page 10.

Weapon and Ammunition reported order intake of only EUR201m, 32% below the previous year, but we are expecting a significant acceleration of the order intake for the second half, including a larger three digit million Hungarian ammunition order.

Sales declined 10% to EUR251m, which is far less than the EUR60m pull forward effect to Q1, because we were able to compensate most of that with very profitable business. Therefore operating margin rose in Q2 to 11.5%. The improved cost situation delivered an additional support to the margin improvement.

Operating free cash flow improved substantially from minus EUR70m to only minus EUR22m, also largely driven by favorable development of trade receivables Moving on to page 11.

The order intake for Electronic Solutions more than doubled to EUR226m and included a large international air defense project. Sales declined to EUR195m, because Gladius soldier systems are now phasing out and new projects are scheduled for a later start. However, the margin quality in Q2 was very strong which in combination with the continued strict cost management lifted the margin by 130 basis points to 9.5%.

Operating free cash flow declined by EUR35m to minus EUR47m due to project preparations that burdened the working capital.

Please turn now to page 12 for the details of Sensors and Actuators.

As some projects were delayed into later in the year, booked business declined by 42% to EUR295m. The share of alternative powertrain products remained however high and accounted for 25% after 21% in the first quarter of 2021. The sales rebound of 88% to EUR325m compares to the very weak COVID quarter Q2

2020. A further improvement on the topline was held back by the chip-shortage with a total effect of around EUR40m in the second quarter, slightly higher than the originally anticipated EUR30m communicated during our Q1 call. The operating result returned to positive territories and grew EUR48m to EUR23m, yielding a margin of 7.1%. Key drivers were higher volumes and that our cost savings measures fully remained in place. Operating free cash flow materially improved on the earnings recovery from negative EUR66m to plus EUR10m.

Please continue on page 13.

Booked business of the division Materials and Trade rose by 10% to EUR154m, successful acquisitions of new customers and the expansion of our product range were the responsible drivers. Sales rose by 56% to EUR161m supported by bearings and trade. The operating result increased strongly and reported a margin of 8.3% after a negative margin last year. Again strong volume recoveries and the sustained cost discipline helped us to reach this development. The at equity contribution of the castings business accounted for EUR1m compared to minus EUR0.3m in last year. The positive earnings effect on the operating free cash flow was partially mitigated by growth driven working capital increases. Please turn to page 14.

Especially Diesel sales for light vehicles and trucks reported outstanding growth, increasing both by around 127%. Driving factors were new project wins in light vehicles and especially higher demand for truck products in China and India after the introduction of stricter emission regulations. The sales increase for the LV business of 91.3% was only little below the HIS growth of 96.4%, but our sales decline in Q2 2020 not as bad as the decline of the relevant global production volume, so we are comparing Q2 2021 to a higher base than IHS. Please move on to page 15.

The sales decline of our China business of minus 13.5% was clearly above the general market decline of minus 3.9%. Key reason was the over-proportionate sales decline of our local core customers VW and GM who account for almost 75%

of our Chinese sales. Their sales, of VW and GM, decline reached 25% in the peak. This volume reduction and the extreme price hike since March for aluminum were the driver of the earnings contraction. Currently, we are negotiating with our customers regarding their participation in the recent price increase. Please continue on page 16. Market fears of a COVID-related reduction of the German defense budget have proven to be unfounded looking at the latest budget proposal. In fact, we are now expecting a record budget of above EUR50b for Germany including a 23% increase of the procurement and R&D share, both the key components for Rheinmetall activities. Similar developments were observed in all our home markets, so we are not expecting any COVID-related budget cuts for the short-term. Please scroll forward to page 17.

Another market concern related to a potentially elevated export risk under a government including the Green party.

First of all, we came to the conclusion that after reading the party manifesto, the Green Party has a constructive approach to both the Bundeswehr and the German industry and a clear idea regarding export regulation for defense goods, which is not more restrictive than the current situation. Secondly, and this might even be more reassuring, our exposure to countries outside the NATO universe has decreased significantly from 35% to 12% over the years and is expected to shrink further and these exports do normally not face any issues. Let’s continue on page 18.

Our continued strong order intake has driven the backlog for the divisions vehicle systems, weapon and ammunition and Electronic Solutions to a new record level of more than EUR14b. Including our shadow backlog, we are almost at EUR18b and we are expecting some big tickets in the future. Please turn to page 19.

Momentum for electrified vehicles has picked up speed, mostly stimulated by governmental subsidies or tax privileges. The development of our booked business also follows this trend and we can report an increase of 96% for the first six months compared to last year in our division Sensors and Actuators

Our portfolio serves battery electric, hybrids and fuel cell driven vehicles with products like for example high voltage cooling pumps, climate compressors, hydrogen recirculation blower and cathode shut-off valves.

On page 20, I would like to present to you the elements of our capital allocation policy, which most of you will find quite familiar. In order to gain more flexibility and to widen the toolbox for shareholder participation, share buybacks have been re-added to our capital allocation policy.

We continue to put a strong emphasis on the organic and inorganic growth of the company supported by our record backlog and to focus on targeted acquisitions. But we are convinced that share buybacks offer an additional instrument to increase the attractiveness of the share.

This brings me to the last slide with the presentation of the trading update and the FY guidance on page 21.

We are expecting again a strong order intake in the third quarter. The sales growth is expected to be around 5% and the margin should be in the range of 7 to 8%. We confirm the full year guidance on group level for sales growth and operating margin and for the latter, we expect to meet the upper end of the range. And having seen the strong cash performance in H1, we are now predicting a free cash flow ratio of at least 4% this year.

Thank you very much for your attention. I am now ready for your questions.

[0:18:57] Operator

Thank you. Ladies and gentlemen, if you would like to ask a question, please press nine and the star key on your telephone keypad. In case you wish to withdraw your question, please press nine and star again. Please press nine and star to register for a question. And we start with the first questioner, it is Sven Weier from UBS. Over to you.

[0:19:46] Sven Weier

Yes, thank you Operator and good afternoon. Hallo Herr Merch.

[0:19:51] Helmut Merch

Hallo.

[0:19:46] Sven Weier

Hallo. Two questions from my side, please. The first one is on the Defense backlog that you have just outlined in the presentation. I can see that the backlog for delivery next year is like 600 million higher than at the same time last year. So, does that mean we should be preparing ourselves for kind of a mid-double-digit growth rate for the Defense business as a whole next year? Is that the kind of foundation for that?

[0:20:22] Helmut Merch

Actually, no. We are not guiding explicitly a growth rate for 2022 at this stage. But what we can learn from this figure is that we expect the acceleration of growth of our top line for our Defense divisions. And this, like I have stated several times, so, we will see this acceleration compared to the last years in 2022 and 2023. For more details, I think we have to wait until March next year.

[0:21:01] Sven Weier

And you spoke about the ammunition orders in Q3 which seemed to be quite sizeable. Is it fair to assume that some of these will be also for delivery already next year or is this really beyond the delivery time, beyond when they actually have the tanks, so to speak?

[0:21:19] Helmut Merch

No, we would start with deliveries already in 2022 and we expect in the second half of this year ammunition orders in the range, the big ones, in the range of up to EUR1b.

[0:21:39] Sven Weier

You mean all combined or even individually?

[0:21:43] Helmut Merch

No, no. Only two or three orders. Then we have the normal businesses, additionally.

[0:21:51] Sven Weier

Okay. Sounds good. The second question is just on the capital allocation point that you just addressed, and you have now added back the buybacks to the list. I was just having a few questions on that. First of all, is there a kind of a pecking order that you showed there or can the priorities differ by the moment in time? Because, at first sight, it looks like share back is the least preferred option on the list. But is that the right understanding of the slide?

[0:22:25] Helmut Merch

I try to explain. We have now widened our toolbox and therefore we look a little bit more positive to a potential share buyback compared to the past.

[0:22:44] Sven Weier

And in terms of capital allocation -

[0:22:47] Helmut Merch

If it would start in this way, we would not stretch it over years.

[0:22:57] Sven Weier

Okay, and the reason why you have added it now to the list? Is it because the share price keeps on being negatively impacted maybe by the ESG transition that is going on and it is up to you to be the incremental buyer for transition period? Is that the right way of looking at it?

[0:23:19] Helmut Merch

I think we have to look carefully to our liquidity. We have a high cash position and in case we would not find any attractive M&A target and we would also proceed with the announced raise of our payout ratio, having then still enough cash, I think we have to look for a useful target of this cash position. I think share buyback on this level could be an attractive alternative.

[0:24:09] Sven Weier

But as you said it, you don’t think it makes sense to stretch it over too much time so if you do buyback, it is not going to be spending two or three years on that?

[0:24:18] Helmut Merch

No, definitely not.

[0:24:21] Sven Weier

And can you just update us, I mean, on the M&A side, I think my impression was that the only really maybe more meaningful target was the RUAG business. Is there any update on that and in terms of your eagerness or interest in the business? Has that changed against Q1?

[0:24:38] Helmut Merch

No. We have a running process regarding the simulation business and bidders were invited to give their final bids and, in this process or in this phase, we are actually in, we are one of the final bidders and now we have to wait what is the reaction of the seller and then we will see what will be the final answer. The process around the Small Caliber business has not yet started again.

[0:25:21] Sven Weier

But anyway, it is probably fair to assume that those two businesses would not require a big part of your excess cash, so to speak? Or even after those fields, you still have cash available for the other things?

[0:25:35] Helmut Merch

We will get no target for free. That is for sure, but I think especially the Simulation business is something which is not, from our perspective, which will afford not very high prices but the potential acquisition of the Small Caliber business that would be clearly a higher amount. But still, as you know, we have a positive and good cash situation and therefore we are fine with the actual outlook.

[0:26:29] Sven Weier

Understood. Thank you, Mr. Merch.

[0:26:31] Helmut Merch

Welcome.

[0:26:35] Operator

The next question comes from Ben Heelan from the Bank of America. Over to you.

[0:26:42] Benjamin Heelan

Yes, afternoon guys. Thank you for taking my question. I have got two. First, you were saying you expect a limited impact from the Auto's chip shortage in Q3 and I think several of the auto suppliers are saying they see more meaningful disruptions and that. So, can you talk a little bit about why you are only expecting a limited impact? And then secondly, a couple on the Pistons business. Could you give us an indication of what is the carrying value of that business on the balance sheet today and is that consistent with how we should think about proceeds from the sale? Thank you.

[0:27:23] Helmut Merch

So, starting with the second question. The carrying value is roughly 90 million. What we have for our Piston business and the whole Piston business, as you know, which is for sale is having a sale volume of around EUR500m plus our participation in JV activities. The first question, I have to remind that I do not explicitly comment on our expectation regarding Q3 and the impact of chip shortage, but if you ask me, I give you an indication. We expect, after having seen 40 million in Q2, we expect in Q3 an impact of 15 to 20 million for the Sensors and Sctuators business.

[0:28:24] Benjamin Heelan

Okay, that's clear. And then back on the Pistons business, is that 90 million how we should be thinking about proceeds from the sale?

[0:28:36] Helmut Merch

This I cannot answer because we are in an ongoing process, and we think that this should be a senseful value, but I cannot give you our expectation of the proceeds because we are in negotiations with bidders and therefore, I will not disclose any further information.

[0:29:05] Benjamin Heelan

Okay, very clear. Thank you.

[0:29:08] Helmut Merch

Welcome.

[0:29:13] Operator

And now we're coming to the next question there. And it is Richard Schramm from HSBC.

[0:29:21] Richard Schramm

Yes, good afternoon Mr. Merch. I was surprised to hear that your tier by the aluminum price increased in China so hard because I thought there would be some price escalation clauses helping you here to push forward these unexpected material price developments to the OEMs or to your customers. Is it so that you do not have this option so that you really fully sit on the risk of material prices, which I think would be really higher risk than I assumed in this business? Thank you.

[0:30:08] Helmut Merch

Yes. So looking to the past, and we did it, we have seen that the Chinese aluminum market historically showed clear lower volatility over the last five years due to the governmental influence. It was not usual instrument to work with price escalation clauses. Therefore, our coverage with material escalation clauses in China is limited. We are now in discussions with the customers to renegotiate our contract, but this is a fact and so we had a real impact in Q2.

[0:31:08] Richard Schramm

So did I understand you aright, that this is really limited to the Chinese market and that in other markets you have these price escalation clauses working?

[0:31:21] Helmut Merch

Yes, Mr. Schramm, definitely. That is only limited to our Chinese joint ventures. All the other worldwide business we have, we have material escalation clauses in place up to 70% or 80%. The rest is being hedged at the London Metals exchange. So therefore we have not really worried because of the recent raw materials increase. There are some minor impacts but this can be compensated. But this I have explained is only limited to the Chinese market and the Chinese joint ventures.

[0:32:09] Richard Schramm

Okay, thank you. Referring to the other costs we have seen exploding, especially on the logistics side, what is your position there? Is this also something you don't have to worry about as you can pass it on to customers? Or is it a burden for you which might cause some trouble in the coming month ahead?

[0:32:36] Helmut Merch

So this is a real challenge. But anyhow, we are trying to pass the cost effects through to the customer. But yes, there is a challenge. We have also some minor hits on the EBIT but this is all reflected in Q1 and Q2 figures and also reflected in our guidance for the full year.

[0:33:07] Richard Schramm

Okay. Thank you very much.

[0:33:09] Helmut Merch

Welcome.

[0:33:16] Operator

The next question comes from Alexander Hauenstein from DZ Bank. Over to you.

[0:33:25] Alexander Hauenstein

Thank you for taking my questions. I have three questions. Maybe we can take them one by one?

First of all, could you please provide us with an update about the Rheinmetall, KMW- Nexter potential combination topic? What is the current status here, is the task still on the agenda somehow? Or is it completely off for the next two years at least? Is there any timetable, maybe? I don’t know. That was my first one, please.

[0:33:50] Helmut Merch

Yes. So Mr. Hauenstein, this topic is completely off the table. Why? Last year Nexter and KMW announced publicly that they wanted to join forces or combine forces forever. We explained in the recent years that there could be still an opportunity in December 2020 to break the combination. But both parties have decided to united, to be together, and therefore for us the topic is completely off the table.

[0:34:26] Alexander Hauenstein

Okay, understood. The next question, can you quantify the impact for your EBIT actually from the withdrawal of the Bundeswehr out of Afghanistan? I mean, which sub-divisions are negatively affected the most here and is the impact becoming visible to us? Or is it over-compensated by products and various contributions from incremental arbitrage?

[0:34:57] Helmut Merch

No. The withdrawal of troops will have no impact on our business. We have contributed to the deployment with services and some spare parts. But this has decreased year by year. So now the complete phasing out will have no impact because of other countries and other programs which are ramping up. So no impact, full stop.

[0:35:30] Alexander Hauenstein

Okay, thanks.Coming to the raw material or especially the semi issues, I understand also that you're doing a bit better than some of your peers. My question is a bit deeper. Any kind breaking points from where you might suffer more again? Or is that something which you expect to phase out over the next couple of quarters? Or are we going to see a risk that it continues into the next year, you suddenly might end up with a quarter being confronted at much higher cost?

[0:36:09] Helmut Merch

Sorry, Mr. Hauenstein, we had some breaks in the line. Can you rephrase your question? I got not the content fully.

[0:36:18] Alexander Hauenstein

Okay. I hope you can hear me better now again. I just wanted to come back on the question of semi shortages and other shortages as well. It seems like you're coping much better with it, and you explained a bit. So my question is, do you expect this to continue? Or is there a potential breaking point from which onwards you might suffer more again? So that we could see eventually at the beginning of next year or so, another quarter where you suddenly might see much of a higher impact again? Or as you mentioned, Q3 will be lower in terms of impact that's fading out on us? Any comment on that?

[0:36:59] Helmut Merch

Yes. Yes, now I've got you. So I tried to give you an indication of how big our estimation or we are expecting the impact for Q3. So this range of 15m to 20m is actually what we see so far. But I have to admit, we are working on a day-by-day schedule with our suppliers. I do not want to disclose the name of our suppliers, but it is a daily fight to get enough material.

What I can say so far, looking at the recent figures of IHS for July, here we see a decline of roughly 7% and our automotive related business has shown growth in July. So probably we are in a slightly better shape, but I only can state what I know today. I do not know and I have no crystal ball, I do not know what could happen in eight or nine weeks. What we see so far, that everybody is trying to overcome and to cope with the situation.

I think for my understanding we saw the trough.But anyhow, if there will be an accident in one of the major plants, then we will have a total different situation in Q3 or in Q4. So what we can overlook is what I have commented on. So we see an impact of up to EUR20m in Q3 and what we expect for Q4 I will provide information during our Q3 call.

[0:38:57] Alexander Hauenstein

Okay, thanks for the update on that front. Understood. All the best, thanks.

[0:39:02] Helmut Merch

Welcome.

[0:39:06] Operator

Next up is Chloé Lemarié from Exane BP Paribas. The floor is yours.

[0:39:13] Chloé Lemarié

Yes, good afternoon, Mr. Merch. I have first a couple of follow-ups on Ben's questions. The first one on the Q3 chip impact of EUR15m to EUR20m. Now I just wanted to make sure there's an incremental headwind from Q3 sales.

The second question is on the piston disposal. So it is EUR90m-ish value on your balance sheet. Theoretically, given that you're in a disposal process, then you have to take additional charges if you have tangible grounds to believe you would not recover that value in that process.

Then on the share buyback, could you help us understand the potential amount that you would dedicate to this, given that you've mentioned up to EUR1.5b M&A fire power in the past. Should we assume that in the absence of a success in the small caliber business acquisition, ammunition from RUAG you'd be considering to give that kind of number back into the buyback or would it just be a fraction of this? Thank you.

[0:40:19] Helmut Merch

Yes. So sorry that I will not disclose what we have in mind regarding share buyback. This has to be discussed within our board and if we have a final decision, we will inform the financial and capital markets. Sorry for that. The first question and second question, because of the bad line, can you rephrase the first and second question? Because I really got problems to understand the whole question.

[0:41:06] Chloé Lemarie

Yes sorry. So the first question was on the Q3 shift impact to make sure that the EUR15 to EUR20m you mentioned, is that incremental headwind versus Q2 sales? And the second one was on the piston business. If you, in theory, if you had to take additional charges versus the 90 million euro valuation that you have on the balance sheet, given that during the disposal process, and if you have tangible ground to believe you may not recover that value in that disposal process.

[0:41:40] Helmut Merch

So the first question, I want to answer as follows. When we are guiding for an impact up to EUR20m due to the chip shortage, we expect a growth for Q3 compared to Q2,. But this growth is limited due to the chip shortage. And this impact is the actual expectations of up to EUR20m. Is that what you want to address? Or is there additional question?

[0:42:48] Operator

Chloé, now we can't hear you anymore.

[0:42:51] Chloé Lemarie

Sorry. I let a couple people ask their question and I will take follow-ups offline.

[0:43:03] Operator

Okay thank you. Then we are coming to the next questioner. It is Sash Tusa from Agency Partners.

[0:43:12] Sash Tusa

Thank you, Mr. Merch. Actually my questions have already been answered. So thank you very much.

[0:43:19] Helmut Merch

Okay, thank you.

[0:43:22] Operator

And next up is Joseph Ayoola from Morgan Stanley. Joseph, the floor is yours.

[0:43:30] Joseph Ayoola

Hello, good afternoon and thank you for taking my questions. I have three if that's okay. The first one is just on cash and obviously good news about the increase of the full year guidance to 4% of sales. Was there any element of that which is potentially pulled forward? Or could you give a bit of color as to what structure and maybe what timing would've been mapped?

And then looking forward in your midterm sales, in your midterm cash guidance, could you maybe give a flavor as to what you've seen for prepayments going forward as well? Should I stop there and then go one by one?

[0:44:08] Helmut Merch

Yes that would be better one by one. Otherwise we could miss some of your questions, content-wise. So the cash generation is clearly impacted by down payment and milestone payment, but this is due to our business profile. I always said that we have a lumpy cash situation in the defence related divisions and a steady cash situation in the automotive-related part of our business. So now we have a strong order intake. We received down payments, on the other hand, we have a continued ramp up of new programs which combine also milestone payments.

So therefore with the ramping up, with the acceleration of top line and the earnings improvement, also the cash flow profile will be better. And this was, by the way, also the reason when we indicated in our February capital market update that we will raise our target range for free cash flow from 2-4 or to 3%-5%. And I think this is clearly dependent on our future expectation for the business.

[0:45:44] Joseph Ayoola

Okay great. The second question was just on balance sheet in general. I know you obviously aren't giving numbers around the buyback. But I was also hoping if you are able to remind us how you think about balance sheet headroom overall, what metrics you look at, and potentially what you'd fear at the upper end of leverage like take on a balance sheet.

[0:46:08] Helmut Merch

Once again also here regarding share buybacks, I do not want to disclose the potential volume. We will inform capital market when we have decided when and how much.

[0:46:28] Joseph Ayoola

Understood. But my question was just about how you think about target leverage as a whole. Given obviously you're in a net cash position today, where will you be comfortable taking that and what do you look at in terms of leverage a balance sheet and then how you think about what's a healthy level for the business?

[0:46:49] Helmut Merch

Yes, I guess what we have also stated several times, we feel comfortable when we have an equity ratio between 30 and 35%. We have seen a decline last year due to the high impairment of the piston business. Now we see some recovery and we also have some tail winds from the higher interest rate which gives us some relief on our pension liabilities and therefore also increase our equity ratios. So this is one of our KPIs still to have at least an equity ratio of 30%. And then all other measures will derive from this situation.

[0:47:50] Joseph Ayoola

Great thanks. And then my final question was just on the UK market where clearly one of your competitors is having a fair bit of trouble on their vehicle program. I was wondering whether you're potential having discussions of the customer around potential contingency plans? And then also, you've obviously get a new book for challenger upgrade this quarter. Would you be able to give any potential size and timing of Ammunition opportunities there? Thanks.

[0:48:22] Helmut Merch

Yes. So I think UK will be one of our already existing, but also our future home market. When we have won, the MIV contract, the Boxer contract and the other Challenger upgrade, we have clearly strengthened in our market position in the UK and we are in ongoing discussions with the MoD in the UK for further programs. So we are very excited of the future potential in the UK, and also our partner MoD is excited of what we can offer to them. And we are exactly meeting their profile of demand.

And the potential ammunition order for the Challenge upgrade, this is one of the medium sized contracts we are waiting for in H2 this year.

[0:49:33] Joseph Ayoola

Great, that's very clear. Thank you very much.

[0:49:36] Helmut Merch

Welcome.

[0:49:40] Operator

The next question comes from Christoph Laskawi from Deutsche Bank.

[0:49:47] Christoph Laskawi

Good afternoon and thank you for taking my question. Small ones, really. The first one will be on the German budget, which is just above EUR10b. Given you should probably assume fairly stable share of wallet, but we don't have a good visibility on the mix within the budget. Could you comment on if there's potential upside to the usual run rate of orders that youfactor in for Germany so that you could go, say, above the EUR1.5b to EUR2b or so to come in next year? That's the first question, I'll take the second later.

[00:50:27] Helmut Merch

No. Here, we have to look that there are not only the army, especially the naval forces and the airborne want to place a lot of projects. So we will be in the range which we have always indicated, EUR1.5b up to EUR2b, not affected from a higher budget as we've seen it for 2020. But this makes our range of EUR1.5b up to EUR2b still more safe. And for further indication also this year, we will achieve an order intake in the range of EUR1.7b up to EUR1.8b. So this is more or less one third of all total intake, order intake. And I think this, to have as a steady volume for the next couple of years, that would be great. And we are very happy with this outlook.

[00:51:36] Christoph Laskawi

Agreed, and would also agree that it's very reassuring to see those numbers going up. And the second question will be on the NATO share that you show on the backlog. Assuming that we'll see no further deterioration of the export restrictions later this year, should we think about the share being fairly constant or stable from this point on? Or when you look at the pipeline, should the non-NATO share move into single digit in the coming three years?

[00:52:06] Helmut Merch

Presently, I would say no. I think to have a share of around 10% is quite good, quite normal. We are living in a restricted area, especially in Germany. But as you are probably aware, with the operational and production site in UK, with the new production site in Hungary, with a production site in Australia, we have a very huge potential in case we have established our intellectual property rights in those countries to open up new markets. And therefore I would not assume that we will fall into a single-digit area. We want to open our business areas with the different operational sites, that we have built up or we are in the process of building up. But I think medium term, now I jump into the next 10 years, for instance, to have one quarter of sales in non-NATO countries and three quarters in NATO countries. That would be also a constructive and healthy proportion.

[00:53:42] Christoph Laskawi

Thank you very much. That's all for me.

[00:53:45] Helmut Merch

Thank you.

[00:53:49] Operator

The next question comes from Sebastian Growe from Commerzbank. Over to you.

[00:53:55] Sebastian Growe

Yes. Good afternoon, everybody. Hi, Mr. Merch. I'm sorry, I've been joining this call a bit late, so I hope that this is not repetitive. If so, then just give me a hint. The first question that I would have is around the pistons exit. Have you spoken about the timelines? I think initially you pointed to quarter three, eventually it might fall into quarter four. So whatever you might be willing to share, I take it. The same goes to any – or goes for any potential comments on exclusivity. Where are you standing here? Because I think you initially talked about 20, 25 parties, if I remember correctly. Have you narrowed that down and to what extent? So that will be the first area of questions.

[00:54:35] Helmut Merch

Yes, so clearly we have narrowed it down, but as a process with several parties involved, we will not disclose any additional information. But what I can say so far is what I stated in introduction due to the ongoing COVID restrictions regarding traveling, we will see some delays. So I actually would now assume that the whole process will delay from Q3 into Q4.

[00:55:19] Sebastian Growe

Okay. That's helpful. The other question that I wanted to ask around the quarter three outlook; you pointed to 5% sales growth roughly in the third quarter. Have you specified that any further, how that might eventually unfold by divisions? And I'm asking that question obviously because the comparison basis in the former auto-related activities, it's rather high, I think. And as you also pointed to the continued headwinds from the chip shortage, so any more color around how that might kind of break out between the two – for the former two divisions, that would be helpful.

[00:55:55] Helmut Merch

So we do not want to give a precise guidance on a division level because then every information would be out. So our guidance is on Group level because we do not know all the different issues which might be ahead of us. But what I can say so far, that we will see further growth in the ammo division. We will see further growth in Vehicle Systems, and especially also in Sensors and Actuators, and Materials and Trade. So the automotive-related divisions will show also single-digit growth. We will see also once again a slight pause in Electronics Solutions, and here we will see the catch-up effect in Q4 to reach final numbers.

[00:56:55] Sebastian Growe

Okay, that's helpful. And the last one is on defense and you made already some comments obviously around ammunition ecosystems. And especially when one looks at the first half development and obviously within the defense business, it has been only one area that was ammunition with positive growth rate. My question is more around the full year outlook. Would you really expect all divisions to resume to positive growth for the full year of 2021 in the defense activities?

[00:57:25] Helmut Merch

No. Two divisions will show growth and one division will remain on last year's level. And this will be Electronic Solutions.

[00:57:39] Sebastian Growe

Okay. And the very last one then on the order pipeline, because your point is obviously of the two pretty good order pipeline for the third and upcoming quarter. Well, we have seen obviously pretty broad ranges over the last three, four quarters. The question is simply if you can narrow that down a bit further, so if you are expecting any further really big ticket wins. And sorry, I'm making the point again, I've been joining this call late. So if you have –

[00:58:06] Helmut Merch

That is no problem. No problem, Mr. Growe.

[00:58:07] Sebastian Growe

My apologies.

[00:58:09] Helmut Merch

So regarding order intake for Q3, we expect the range of EUR1.5b up to EUR2b. And then we also see – have some good expectations also for Q4. So in total, what we are seeing actually will be in a range of EUR5.5b up to maximum EUR6b. And these figures are not including a contract from Slovakia or Czech Republic because here, the latest information is that these potential orders will slip the one into 2022 and the other, the Czech order will more or less slip into 2023. That does not mean that negotiation will start, but this is our latest information from the customer signing from the Slovaks more or less in H1 2022 and from the Czechs more or less in H1 2023.

[00:59:25] Sebastian Growe

Okay. That's helpful. All from me, thank you so much.

[00:59:29] Helmut Merch

Okay, thank you.

[00:59:32] Operator

At the moment, there are no further questions. So if you have any additional questions, please press nine and the star key. Please press nine and star to register for a question. And there is another questioner, and it’s Christian Cohrs from Warburg Research. The floor is yours.

[01:00:02] Christian Cohrs

Yes. Thank you. Just one question for me, Mr. Merch, and this is actually related to the minority expense. Minority expense in Q2 has gone up considerably year over year. I mean, in the past, minority expense were related to the Defense business, but looking at the Defense divisions, Weapon and Ammunition flat, Electronic Solutions flat, the ecosystem even moderately down year over year. So what is actually the background? What happened on the entities that yes, minority expense as a whole has gone up considerably?

[01:00:42] Helmut Merch

Yes. So if you look to the Q2 figures, then we have a swing of roughly EUR17m from a minus EUR3m in Q2 2020, now to a positive figure of EUR13m. So swing is roughly EUR16m or EUR17m. And two companies were supportive. That is our company in South Africa, Rheinmetall Denel. They showed a minus of EUR4m last year and now a plus of EUR1m. And we have extreme good performance in our joint venture with TRATON, the RMMV. Here we have a positive swing of EUR10m quarter to quarter. And if I jump back into the first six months, there we have a swing of EUR21m and 19EURm of the EUR21m were given by the joint venture RMMV and secondly by Rheinmetall Denel.

[01:01:58] Christian Cohrs

Okay. That's helpful. Thank you very much.

[01:02:01] Helmut Merch

Welcome.

[01:02:05] Operator

Mr. Merch, there are no further questions.

[01:02:10] Helmut Merch

That is fine. So then I can close our Q2 earnings call. I thank you all for your participation, for your questions and I hope we will see us in person in the next couple of months and at the very latest point we hear us in our Q3 call early November this year. Bye-bye, and have a good time.