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Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Natalia Valtasaari

Head-Investor Relations, Kone Oyj

Good afternoon and welcome to KONE's Third Quarter Earnings Call. My name is Natalia Valtasaari, I'm KONE's Head of Investor Relations, and I'm very pleased to be joined here today by our President and CEO, Henrik Ehrnrooth; and by our CFO, Ilkka Hara.

As usual, Henrik will take you through the key highlights of the quarter, both in terms of market and business performance; Ilkka will then follow-up with a bit of a deep dive into the financials; and Henrik will wrap up with a summary and the kind of market and business outlook that we see going forward. After that, we'll take your questions.

And please, during the Q&A session, limit yourselves to one question and then one follow-up. You can join the queue after that. But let's try to ensure that as many people as possible have the opportunity to ask questions.

But with that, I will hand over to Henrik.

Henrik Georg Fredrik Ehrnrooth

President, Chief Executive Officer & Member-Executive Board, Kone Oyj

Thank you, Natalia, and a warm welcome to everyone, and good to have you with us today again. Clearly, Q3 had many different situations, both challenging and positive, and we'll talk about both of them today. So, if I start just with the highlights. Perhaps the biggest things during Q3 that impacted our performance overall was, number one, the weakening of the Chinese new equipment market, it's clear that that had a impact on our business in the third quarter. At the same time, what was very positive in the third quarter was a continued, very strong development of our services business in both maintenance and in modernization. So, this, I'm very pleased about.

Another very positive thing in the quarter is that our margins of our orders received continued to improve and, actually, they improved in all geographic regions now, both sequentially and also in total year-over-year. So, we can see that the actions we've been taking to improve our profitability, something that is very high focus for us right now, is going the right direction.

If we start with Q3 and the key figures for Q3. Orders received at just over €2.155 million (sic) [€2.155 billion] (00:02:21) and a decline of 10% in comparable currencies. Here, Ilkka will talk about this in more detail. But China declined clearly, whereas we had growth in rest of the world. Perhaps a positive thing is our strong order book at almost €9.9 billion, 8.4% up year-over-year.

Also, our sales grew at 6.5% in comparable currencies at almost €3 billion and really here the highlight was our services business. Maintenance grew again at the very good rate of 8% and the growth here was driven by a good combination of good growth in number of units in our service base by pricing, but also in continued good progress with our 24/7 Connected Services. So, that was a key growth driver, but overall, broad-based growth that resulted in 6.5%. Operating income at €304 million and adjusted EBIT €306 million, down from €326 million the year before.

It's clear that the decline of margin from 12.5% to 10.2% is not something that we are happy with. It's clear that, from here, we want to improve clearly. What is positive, though, is that we could see that our margins, particularly on new equipment business, that they were at the bottom in Q2 and we now have sequential improvement and we expect and, of course, want to continue to drive improvements from here. Cash flow now at €336 million compared to €365 million a year ago and EPS down 8.5% to €0.46. But as we always say, one quarter is a very short period of time and now we have already three quarters behind us.

And if you look at orders received, stable compared to last year in comparable currencies, close to €7.2 billion. And perhaps again, I talked about the order book, but what is very important here is that this super strong order book that we have, it provides us a very solid foundation going forward. That, in combination with our good and growing service base – as you remember, we don't have our service business included other than repairs in the order book. So, the combination of these two gives us a very good situation going forward, even in a more challenging environment. So, we have a lot to deliver over the coming year or two.

Sales, close to €8 billion, down 3.5% year-over-year. Of course, the biggest impact on our sales year-to-date has been the very significant impact of COVID lockdowns in China in Q2. EBIT – adjusted EBIT at €712 million, down 25% from €950 million and a margin of 8.9%. As I mentioned, this is clearly not something that we are satisfied with. Clearly, ambition is to improve clearly from here and, as I've said, that we have started to see an improving trajectory. And cash flow, now €721 million down from the exceptionally strong €1.3 billion a year ago. And EPS, €0.97 compared to €1.43 year before.

So, we all know that the world economy and the environment has continued to be challenging. When I look at how the KONE team is driving improvement and driving performance in this environment, that is something I'm very happy about. I can see a continued good drive and spirit in the team in driving improvements; everything from pricing, focusing on productivity, and just making sure that we're making progress in our key focus areas. That is something that is very pleasing. We've been traveling a lot around our units in the past months and that is the same message and the same reception one gets everywhere. So, huge thanks again to the entire KONE team for great work and – that they have been doing.

Now then, little bit on some business update. Highlight this time is how we're driving momentum in services, I talked already about what is driving our maintenance growth, combination of all factors. Wanted to give a little bit more insight to our 24/7 Connected Services and modernization. The penetration of our 24/7 Connected Services is now close to 20% of KONE equipment. At the same time, we are also installing 24/7 Connected Services on all other brands, and that is something I think differentiates us in the market, that we can do with both for KONE and for non-KONE branded equipment and that's why we're also starting to approach a 15% overall penetration. But I think, for KONE equipment, we have this good rate now.

Cost and benefits are very measurable, but also, we can see that our conversion and retention rates are improving. Now, what is even more important is that beginning of this year, we launched our new service called KONE Care DX that is specifically designed for our DX Class elevators that we launched in 2019. Now, what is great is this is an evolution of our KONE Care service and our 24/7 connected service (sic) [24/7 Connected Services] (00:07:53) and it was the first carbon neutral maintenance out in the market.

Now, we can see that when we look at conversion rates, we look at pricing, we look at all the measures, they are even better with KONE Care DX. So, the point here is really that 24/7 Connected Services is not a static service for us. It's something we continue to develop and continue to make sure that we can improve outcomes for our customers and for us. And as we've highlighted before, the impact for our customers when we have units connected is that call out rates are 30% lower, entrapments down 40%, and we can see 65% of cases we can proactively identify faults. Of course, making sure that we can do things proactively and more conveniently for our customers and more productively for us.

Now, modernization is also a market that continues to be robust and good. And what is interesting is that we're seeing that classical trends of an aging equipment base that continues to drive modernization. It's very much there. But we also have other trends that are also boosting, particularly the commercial side but also from a sustainability angle, growth here. So, we can see that, for example, offices are getting more modernized than before because if you want to attract, for example, employees back, you need to have a modern and good office. And then, usually when you modernize, elevators are part of that of the package. So, we're seeing more younger equipment being upgraded for adaptability and for better experience.

But also, we are seeing focus on sustainability. We can see in some countries the European [ph] Resilience and Recovery Fund (00:09:31) also subsidizes elevator modernization. So, good drivers here. Even though economic outlook is uncertain, we can see continued good momentum in this business, which is great and we have really taken advantage of it.

Now, as we have said for a few quarters, what is very high up our agenda is to improve our financial performance, in particularly, our EBIT margin. That is a combination of pricing action and more dynamic contract models. Here, we're making good progress. Modernization, we have more than covered the costs or the increased costs. And in new equipment, we're making good progress, still some way to go, but momentum is clearly there.

Another focus area has been to – how can we reduce our product cost through R&D development, offering development, and of course sourcing actions. Here, I will say, particularly the development in China has been great. The China team has done a phenomenal job here. And of course, now, we're also starting to see an easing on raw material costs in China. And productivity also improving order book margins. Then, of course, another driver for our margin improvement is to drive growth in our service business, which we're doing very much so.

Now, we can also, of course, see that, in the past years, the operating environment has changed very rapidly, starting with COVID-19. And then we had, of course, supply chain disruptions, then we had war in Ukraine, and so forth. So, there's been rapid changes and we are, therefore, now planning to simplify our operating model in order to be able to more rapidly respond to changes like this, but also to improve our efficiency and, therefore, to support the improvement of our financial performance. So, that is something that we have – we are planning to do. So, those are some highlights and some updates on where we are on this focus areas.

Then, market development. And if we start with new equipment market, we can see that development has been mixed. North America, we can show – we're showing one minus. So, actually, what happened in North America, in number of units, the market declined a bit, but the market grew significantly monetary value. And we can see our [ph] pro forma (00:12:03) has been excellent in that market. So, we can see that prices – overall price in the market have come up significantly. So, therefore, that continues to be good and robust market.

Europe, Middle East and Africa, mixed. War in Ukraine is clearly starting to impact Central, North Europe, whereas South Europe is slightly better. And although it declined slightly, as well. But the Middle East, of course, with the energy price trends, is doing very well. So, there, we're seeing growth.

China, there was a further deterioration of market decline, about 20% now in Q3. And I'll talk soon a little bit more about the Chinese market. Rest of Asia-Pacific, good development overall. A highlight here is India, which has recovered very strongly after COVID, and developing positively.

So, as I promised, a little bit deeper dive into China. So, market environment did deteriorate further in Q3. And really, the key issue is liquidity constraints for developers. Because of poor liquidity, it's clear that their construction projects overall are moving slower, and therefore that of course impacts our deliveries as well. COVID-19 restrictions, although they are not quite as severe in this quarter, but we have seen rolling lockdowns around the country has had an impact on consumers' confidence and ability to buy apartments.

Maintenance markets continue to be good. Although, now in the quarter, we did see a more mixed modernization activity. Here, we could see that particularly elevators for existing buildings were impacted by overall liquidity and the overall economic situation, whereas then [ph] part (00:13:54) modernization developed better. We believe that this temporary downturn in the modernization market overall in China is temporary and we're going to see an improvement already in Q4.

So, if we look at the various statistics, we can unfortunately see that Q3, when we look at either real estate investments or new starts, that, unfortunately, they did deteriorate further. Where there is some positive development, actually, the trajectory is not quite as bad as it was in the first nine months, now in the quarter, is in completions. Here, we can clearly see that the need to complete apartments that are started, and particularly people that paid down payments, is increasing. So, when that gets going, there's actually a lot of elevators that need to be delivered. So, let's follow that, but that is something that we believe will happen at some point during next year.

Service markets globally continue to be good. I would say, maintenance, we are back at a pre-pandemic growth trend. So, slight growth in Europe, Middle East and Africa, North America; and continued good growth throughout Asia-Pacific. Modernization markets were very strong in the quarter. Perhaps most positive were the North American markets; but also, Europe, Middle East and Africa, good markets, and Asia-Pacific outside of China. As I said, that Chinese market were now temporarily lower, but we think this is temporary phenomenon and the markets will come back there, given the big need for modernizations.

So, overall, we can see that, yes, there are challenges in some of the markets, but some of the markets are robust. And what we have done is that we're really focused on want to grow in the growing markets because that you can do with better margins, and we can see that. And as Ilkka will explain soon, how we're driving growth both in maintenance and modernization continues to go well.

With this, I hand over to Ilkka to talk more about our financial performance.

Ilkka Hara

Chief Financial Officer, Kone Oyj

Thank you, Henrik. And also, warm welcome on my behalf to this third quarter result announcement webcast. I'll review the financials in more detail and I'll start with orders received development for the quarter. So, orders received for third quarter was €2,155 million, on reported basis down 2.5% and on a comparable basis down 10%. If we get by geography, clearly, Americas, we saw very strong performance there, a clear significant growth in orders received, as well as growth in Europe, Middle East, Africa. In Asia-Pacific, excluding China, more stable development. But clearly, in a more challenging Chinese market, we saw orders received declined significantly.

We've talked about pricing quite a bit over the last quarters and we continued to see pricing developing positively in the quarter. We look at overall, we saw pricing improving in all regions. In modernization, we're now at the stage where the price improvements have covered the cost increase that we've seen now. In new equipment, we continue to make progress, but there's still work to be done to cover the cost headwinds that we have. But we are in the right direction in that area as well.

We look at then the outcome, the impact to our margins. So, we saw in the third quarter that our orders received margin improved not only on sequentially but also a year-on-year. And as I said, last time, that's the next milestone we want to get to, in order to get past the cost headwinds that we've seen. And now, we can say that we are increasing year-on-year. So, very pleased to see that now being reached in our third quarter orders margins.

Then to sales, sales for the quarter were just shy of €3 billion. On a reported basis, growth, 14.9%; naturally, on a comparable basis, less so 6.5% growth. Very happy about the fact that we grew in all regions. Strongest growth in Europe, Middle East, Africa, as well as in Asia-Pacific, both growing at 7%. Americas growing at 4.5%. Also from business perspective, all businesses grew; new equipment at 5% and modernization at 8.6%. So, strong number for modernization growth.

But also, what I'm very pleased about is that we continue to see our maintenance performing well, and now we can see the growth for the third quarter to be 8%, and that is a very good number. We see improvement in all numbers, whether it's LIS, whether it's pricing, and also, as Henrik talked about, value-added services 24/7 as an example, contributing positively.

Then, to adjusted EBIT and profitability. So, adjusted EBIT for the third quarter was €306 million and the margin was 10.2%. Clearly, not the number that we're happy about, down from last year's 12.5%. While the growth that we saw in all regions, as well as in all businesses, contributed positively to our profits, and as well as the improvements that we continued to see in productivity, as well as in good control our fixed cost contributing to profitability positively.

At the same time, the cost headwind, approximately €30 million to €40 million for the third quarter, driven by material component, the logistics costs contributed negatively, as well as then the new equipment delivery margins. So, the orders that we're now fulfilling from the past have lower margins, as we've talked about, contributing positively as well – contributing negatively in this quarter. But as we said, now we could start to see the prices improving as we look forward. Then also quarter-on-quarter from the last third quarter of last year, we've seen orders margins improving. So, that would be a tailwind for us going forward.

Then, to cash flow, which for the third quarter was €336 million. While operating income declined, contributed negatively, the change in working capital was slightly negative in the quarter. So, slight decrease in advances mainly driven by the orders development in China, as well as a slight increase in accounts receivable, and the timing of our accounts payable now contributing positively. There's always, between the quarters, some timing differences so we expect that to reverse in the coming quarters as a result. But all in all, good cash flow for the business in the quarter – third quarter at €336 million.

But with that, I'll close the financial part and hand over back to Henrik to cover market and business outlook for the rest of the year.

Henrik Georg Fredrik Ehrnrooth

President, Chief Executive Officer & Member-Executive Board, Kone Oyj

Thanks, Ilkka. And then, if we look at the market, what do we think for total 2022, of course, we only have a quarter to go now. But if we look at new equipment markets, continuing to see a mixed situation with new equipment market in China. We now expect it to decline by over 20% for the full year 2022. Last quarter, we still expected about 15%. So, we have seen a deterioration in the outlook and that's, of course, due to the liquidity situation principally. EMEA, overall, pretty stable and North America, we got a good growth beginning of the year and, of course, because of the value growth now growing in Asia-Pacific, excluding China, also developing positively.

Modernization of markets, we expect them to continue to grow across regions and be good and robust. And maintenance markets have returned – actually, continue on their pre-pandemic growth trajectory. So, good growth opportunities in many parts, [ph] of the actual (00:22:42) parts of the world and [ph] best mature (00:22:44) in Asia-Pacific.

Then, our business outlook, we now expect our sales to decline between 1% and 4%. So, this, we updated roughly a week ago, almost two weeks ago. And we expect now our adjusted EBIT to be in the range of €1.010 billion to €1.090 billion. Of course, assuming that exchange rates don't change a lot from October 2022.

What is driving our performance? It's clearly the outlook in services and our strong order book. There's plenty for us to deliver going forward. And also, we are now starting to see the impact of product cost, productivity, and pricing actions. As we always said this, that they will start to be seen towards the latter part of the year and we expect to start to see some impact of that in Q4. But of course, what is burdening our result is clearly €200 million still headwind from material, logistics, and component costs and deteriorated environment in China. Supply chain constraints continue to be a factor. Although we expect supply chain challenges to ease, supply chains continue to be constrained in many parts of the world.

Now, as we are already in the last quarter, we wanted to give a sneak peek into 2023, what we expect to be drivers of positive and also challenges for next year. Clearly, what is positive going into next year is we have very strong order book and the improving margin of orders received. So, gradually, we start to see that coming through. It's clear that orders that we book today, we can only see the margins roughly a year out, but still, we have clearly throughout this year gradually improved our pricing. So, that will start to be seen next year.

Services, we expect continued positive momentum there. And also, in Asia particularly, easing commodity cost headwinds and somewhat improving component availability. In Europe, commodity headwinds continue to be there because of the energy crisis. But Asia, we start to see a clear improvement there.

What are then the more challenges going next year? It's clear that the slowing rotation of the order book in North America, it's more of a labor constraint issue. In China, it's clearly a liquidity issue. And therefore also, the continued liquidity constraints and COVID restriction in China, likely to have an impact. Wage inflation, clearly impacting also cost next year.

And then, what is an unknown are geopolitical tensions on global supply chains. Clearly, the very tragic war in Ukraine continued to have impacts, but let's see if we have something else. So, that's kind of an unknown for next year. So, there are both good things and challenges that we are we are proactively dealing with.

So to wrap up, clearly the environment in China, and given our size there, impacted now our business in Q3 services. Services, great continued progress. That, I'm very happy about, as well as a good progress in pricing overall in all businesses. And then also, we are planning to simplify our operating model to also support long-term financial performance.

But with that, we now have plenty of time for your questions or comments.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] We ask that you please limit yourself to one question plus one follow-up. Your first question comes from the line of Klas Bergelind from Citi. Please go ahead.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.
Q

Thank you. Hi, Henrik and Ilkka. Klas at Citi. So, my first question I had was on the operational gearing in the quarter. Your China sales seems to be up slightly and you have reiterated the [ph] cost again of (00:26:53) €200 million, with some €30 million, €40 million in the quarter. Despite this, your operational gearing disappointed in the quarter.

I hear you on the [ph] lower (00:27:01) equipment margin coming from the backlog, but to what extent is this also other cost inflation such as wages kicking in and if you could help us with the wage inflation in the quarter and your expectations going into 2023? I'll start here.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj
A

Do you want to start with that?

Ilkka Hara
Chief Financial Officer, Kone Oyj
A

Yeah. So, on the wage inflation, as we've talked about earlier, so, yes, we see higher inflation in wages than normally, but it's not that dramatic. It contributes negatively but, at the end, we actually had a pretty good fixed cost absorption. So, some tens of millions that were impacting the – sorry, some tens of millions impact from increasing wage costs, including our installation and as well as our fixed costs. But that's something that has been more stable throughout the year, so it's not picking up third quarter as such.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj
A

I would say, in general, when you look at the quarter, so, clearly, services did well. And when we look at our new equipment margins while they were down year-on-year, still sequentially, we're now starting to see an improvement which was positive. So, clearly, compared to last year, higher costs. Also, we can see that supply chain constraints in some markets did have an impact on this. If we look at certain semiconductor availability, Q2 and Q3 were perhaps the toughest if you go back a couple of years. Now, we see a situation that is improving gradually.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.
Q

Yeah. I guess my question, Henrik, is given that the implied sales guide for the fourth quarter is quite low, right, so – and you are talking about an improving margin again quarter-on-quarter at the midpoint, if the equipment margin would still be down year-over-year on current cost inflation, that means that your pricing – you do not feel very good about pricing coming out of the backlog? Is that how we should see this sort of quarter-on-quarter improvement? Just to get that right. Because I was a little bit surprised about the low new equipment margin out of the backlog?

Ilkka Hara
Chief Financial Officer, Kone Oyj
A

No, I think if you think about our new equipment delivery margins, so they are now sequentially improving in Q3 and we do expect them to continue improving in Q4 as well. And then, obviously, there are many moving parts for the guidance but that's the expectation. We've seen now pricing improving in our new equipment since third quarter of last year and also margins as to that extent. So, all of that starts to then come through in the P&L as well.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.
Q

All right. My follow-up then is a question on the €400 million cumulative inflation from raw mats, components, and logistics. It's obviously good to see the order margin improving year-over-year but that's against the current cost inflation. I'm interested getting the cost out at that current spot levels, how these could develop into 2023. Would you help us on how you think raw mats, logistics, and so forth at current spot rates could sort of impact the bridge into next year? I'll give it a go at least. Let's see what you say.

Ilkka Hara
Chief Financial Officer, Kone Oyj
A

You've been following us too long, so I guess it's a bit too early to start giving a more detailed guidance for next year. We'll come back to that in conjunction with the fourth quarter results. But I guess, what Henrik said already earlier is that we are seeing raw materials and, therefore, component costs as well being a bit of a tailwind in China; whereas, in Europe, they continue to be on a quite a high level given the energy crisis that we have here.

So, a mixed bag, I would say. And let's look at it a bit more in detail when we come to – towards the end of the year. As also, we know that – which orders and where we are delivering. So, give you more details. But I would say, mixed bag, tailwind in China and to the extent we deliver to Asia-Pacific from China. But then, clearly, Europe is a different development from that perspective.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.
Q

Got it. Thank you.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj
A

Thank you.

Operator: Next question comes from the line of Andre Kukhnin from Credit Suisse. Please go ahead.

Andre Kukhnin
Analyst, Credit Suisse Securities (Europe) Ltd.
Q

Good afternoon. Thank you very much for taking my question. The question I have really is on the – on your view on the cycle shape in China beyond this year. I'm not trying to elicit some kind of market forecast, but I just really would love to hear what your base case is for 2023 beyond. Do you have a declining further next year, conceptually what do you see as the kind of curve or line after that?

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

So, I think it's too early to give an outlook for China next year because we know that the market in China is very policy driven. What we now have seen is that we have not seen a big change in policies, which would indicate that there's not going to be a huge [ph] sort of – (00:32:24) whole lot of change next year.

There's, however, one thing that we would expect to, sometime during next year, start to become more of a tailwind, is that – there's clearly a need to finish the semi-finished buildings, particularly where people have paid a down payment, and that is a very significant backlog. And we're talking about actually a lot of elevator demand and deliveries there.

That is going to require liquidity for developers to finish the projects, but that is something we could see happening. But other than that, we have not seen a lot of changes in policies. So, a big recovery in the short-term is not something we're expecting.

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

Maybe to add to that then, our view to the service opportunity in China has not changed. So, if you think about last – next years to come, I think it continues to be very, very interesting opportunity, both modernization and maintenance. And that's something that is very key to our strategy also going forward.

Andre Kukhnin
Analyst, Credit Suisse Securities (Europe) Ltd.

Q

Absolutely, absolutely. Thank you for sharing this. And as a kind of follow-up, also my second question, I just wanted to come back to what we discussed before about the pricing actions and the cost out effects that you've already taken. Could you help us with a number of what we should expect for 2023 from what you've done already, what you have got in the backlog already?

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

Well, if I try to give you a bit of a view to that, and then we'll come back with more details for 2023. So, first, if you start with modernization business where, I would say, that the progress has been the best in terms of pricing versus cost. So, now, we are at the stage that we've been able to increase prices for the orders we booked in third quarter to cover the cost increases that we have seen. So, that's very good. And in modernization, order book rotation is faster than the new equipment. So, that should be starting to positively impact our P&L than in the first half of next year.

Then when it comes to new equipment, we continue to see pricing improving. But if I look at our progress in third quarter, so we're roughly in outside of China 70% there in terms of the price covering the cost increases net of our actions. And whereas in China, I think, as you saw in the quarter, the prices did improve like-for-like compared to last year, but there the cost actions that we've taken, our product costs had been much bigger driver in our performance.

And also, if you look at the raw materials, they start to be a tailwind, as I said earlier. So, in that respect, so if you now look at next year P&L impact from these actions, so it is about year – a bit more than a year to see the order book rotating for the orders that we now booked in Q3, which had a positive pricing development. So, that's the way I would try to describe it then. And as I said, we'll come back to that a bit later.

Andre Kukhnin
Analyst, Credit Suisse Securities (Europe) Ltd.

Q

And in that – in the context of the half of the €400 million cumulative [ph] being offset, right, is there kind of background (00:35:56)?

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

I didn't give that detail in total, but it's not a bad proxy as such.

Andre Kukhnin
Analyst, Credit Suisse Securities (Europe) Ltd.

Q

Very helpful. Thank you very much to both of you.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

Thank you.

Operator: The next question comes from the line of Daniela Costa from Goldman Sachs. Please go ahead.

Daniela Costa
Analyst, Goldman Sachs International

Q

Hi. Good afternoon, everyone. Thanks for taking my questions. The first question I wanted to ask regarding your last point, Henrik, on your summary where you said you're simplifying your operating model to drive long-term financial performance. I just wanted to see if you could give more or any more color regarding that? I guess your Accelerate program is done, so should we be expecting like some sort of restructuring or a new program to follow? That would be my first question.

The second question is just a follow-up on one of the questions earlier. You commented on wage inflation for this year. I guess sort of a lot of the macro forecast is for higher wage inflation next year. I know you have escalation clauses in the maintenance portfolio, but you – can you talk about how they effectively get implemented? Would you sort of [ph] fair (00:37:14) wages throughout the year as they are and then get a compensation from the customer at the end of the year or is it happening on a continuous basis and so we should see no impact because you pass on any sort of wage inflation to your customers? So, those are my two things. Thank you so much.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

Thank you. Let me start from the second one. So, usually how it works, so it's – first, there's only a part of the contracts have escalation clauses; others like if you – for example, in markets where you have longer-term commercial contracts, then they may have specified, like in North America, more specified what the escalation is year-over-year. But in North America also, we know much better the labor cost increase than in Europe.

In Europe, which is still the biggest service business for KONE, the way it works is that, in most cases, you have annual escalations; and quite a big part of those happens in Q1. Then, you tend to have – you have a labor cost index, you have a CPI, or you have another specific index; it varies quite a market to market. And you look back 12 months, and that is your escalation clause. And it's clear that we have had quite over-inflation already for a year, so that should be reflected in these indices.

That's why, for example, we're going a year back, even though actually we were able to increase prices quite well or very well, I would say, in maintenance, some of these indices weren't so favorable because inflation really started in the second half of last year and the first half didn't contribute. So, now, I would say, all the indices are more favorable because it's something you usually look 12 months back and what we can then doing in quarter one. So, that's kind of, in a simplified way, the ones that you can escalate, that how it works for them.

Now, then on these plans to simplify operating model, just as a context here, as I mentioned, that it's clear that when we have originally designed our operating model, it was for a different type of environment where not so many changes happened all the time. And now, we are looking at, hey, how can we be faster responding to changes, for example, we have now raised our prices very well, but perhaps we should have started earlier. How do we make sure that we react to situations in our organization faster? Also, how can we be quicker in environments like this and bringing solutions to our customers? And it's clear that we are looking for efficiency metrics as well. So, those are kind of the details we can share right now. And later, you will, of course, hear more about it.

Daniela Costa
Analyst, Goldman Sachs International Q

Thank you.

Operator: Your next question comes from the line of James Moore from Redburn. Please go ahead.

James Moore
Analyst, Redburn (Europe) Ltd. Q

Yeah. Thanks for taking my questions. Hi, everyone. I have just a few follow-ups, really. I've heard all of your qualitative answers on the questions that have been given so far. Just on quantification, I don't know if you could help us a little bit with, one, is there a restructuring charge tied to the new operating model? Two, wage inflation percentage, is it more 3% or 4% this year; and net, does it go up? Some say, goes to 4%, maybe 5%. Raw materials at current prices next year, are you thinking a tailwind or a headwind? If you don't want to give a number, could you just give the direction at the current level? And finally, perhaps most importantly, could you help us with the difference or quantify the difference in any way between the order received gross margin and the current P&L gross margin? I mean, is it a small difference or a big difference?

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj A

Okay. Those were a few questions. I'll let – Ilkka, you hopefully took – wrote them down so you can start [indiscernible] (00:41:02)...

Ilkka Hara
Chief Financial Officer, Kone Oyj A

I think I have, but let's see how well I do. I start actually at the end first, and then work backwards to your first questions. So, yes, we are booking orders on a higher margin than we're delivering right now, but I wouldn't quantify it – that in more detail. But clearly, we expect them to continue to have that tailwind in the coming quarters supporting our profitability improvement.

Raw materials, to help to quantify, so it's too early to say, given the size of China business where we see the tailwind that's naturally helping and expect some help from there. But let's come back to the details when we get to fourth quarter results.

Then, you had question on raw – on labor cost inflation that we see and how – what's the difference? So, maybe that's actually a good way to describe it, if – you were saying that from 3% to 4%, it's now then 4% to 5%, a percentage point or so increase. We see the labor cost increasing more, especially in Europe than we've seen in the past. Much of Asia-Pacific, we've had high inflation for a long time so it's not as big a difference compared to the past. And as said, in North America, our visibility to our own labor cost is quite long, given the labor negotiations. So, yes, a bit more than we've seen in the past but not that dramatic.

And then, on the – and on our operational improvements and the things we're planning to do, let's see, we'll come back with more details later. The planning has been commenced and we'll then update as we go along and we have more detail on that one.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

But it's clear that [indiscernible] (00:42:58)...

James Moore
Analyst, Redburn (Europe) Ltd.

Q

Thanks, Ilkka.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

...it's likely to have some implications, but let's come back to that. But thank you. I think you covered all of them.

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

I tried.

James Moore
Analyst, Redburn (Europe) Ltd.

Q

Okay. Thanks.

James Moore
Analyst, Redburn (Europe) Ltd.

Q

Okay. Thanks.

Operator: The next question comes from the line of Aurelio Calderon from Morgan Stanley. Please go ahead.

Aurelio Calderon Tejedor
Analyst, Morgan Stanley & Co. International Plc

Q

Hi. Good afternoon, Henrik, Ilkka. Thanks for taking the questions. I've got two on China if I may, please. So, the first one is on your order development in China, just looking at your slide, you showed that you had more than

30% decline whereas the market decline [indiscernible] (00:43:35). So, I'm just – I just wanted to check if that's market share driven or it's you consciously not going after orders that don't meet your margin criteria?

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

I would say, perhaps everywhere in our new equipment business in Q3, we focused principally on price and margin, not on gross. That was our principal objective, was to improve our margins not necessarily gaining share or growing units.

Aurelio Calderon Tejedor
Analyst, Morgan Stanley & Co. International Plc

Q

Okay. Great. And in terms of order cancellations, you still mentioned in the release that they remain are very low levels. I just wonder if there's – if you've seen many changes in China, especially given obviously the tight liquidity situation at the developers or are cancellations still in line with what you've seen in the past?

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

Cancellations continue to be – if I look at the full year to start with, the main driver for cancellations this year has been the fact that we exited our business in Russia where we actually then had to, ourselves, cancel the new equipment orders we had in place that we were not going to deliver in China. Overall, cancellations continue to be very similar than we've seen in the past. So, no change there.

Aurelio Calderon Tejedor
Analyst, Morgan Stanley & Co. International Plc

Q

Okay. Thank you.

Operator: Next question comes from the line of Guillermo Peigneux from UBS. Please go ahead.

Guillermo Peigneux-Lojo
Analyst, UBS AG (London Branch)

Q

Hi. Good afternoon and thank you for taking my question. Maybe a follow-up question first and then – on the previous question. So, now that you are increasing prices or being more selective on your order intake maybe for the part that you're losing market share, is it the Chinese companies or is it in Western companies? I stay back and I'll ask the second question later.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

First of all, let's remember, we talk about one quarter.

If you look at year-to-date orders in China, rest of the world, I think we are – we're doing well, better than the market overall. So, this is one quarter and one quarter with particular focus on the margin development. So, it is not something that I would be overly concerned with, and just in line with what we're driving for.

Guillermo Peigneux-Lojo
Analyst, UBS AG (London Branch)

Q

Yeah. If I may follow-up – I understand, but I wanted to understand who is – when you obviously [ph] act as a pricing (00:46:03) leader in the Chinese market, can I ask whether – [ph] is the Chinese companies scooping (00:46:08) the market for those basically customers that don't want to accept the higher price or is it the Western companies that are doing that in the market...

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

I would say...

Guillermo Peigneux-Lojo
Analyst, UBS AG (London Branch)

Q

...in the Chinese market [indiscernible] (00:46:23)?

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

I don't think that there is one single, I think there's a mix. I think in both categories, if you look at the global players and you look at the more local players, I think you can see gains and losses in both of them. So, I don't think you can point out that it's Chinese that would win and global players losing. It's not – I don't think it's like that.

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

No, I wouldn't call out a pattern there, but rather individual cases. And as Hendrik said, still – we've said it in the first half when we're clearly above the market in terms of orders development and now the opposite in third quarter that these quarters are a short time to measure market share, to be honest.

Guillermo Peigneux-Lojo
Analyst, UBS AG (London Branch)

Q

Thank you. And maybe a more difficult question when it comes to new installations in China. And obviously, comparing this year, with last year, could you be able to or would you be able to quantify how much of the margin that has been lost is driven by your inability to install versus your negative impact from price to cost?

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

Well, I think – if I start and you can add, Henrik, if you want. So, majority of our inability to install, as you said, was really about the lockdowns that we saw in second quarter this year. We estimate that to be roughly €500 million in revenue. And the cost impact, including the one-off costs related to – on operating in this, during the lockdowns had to be about €100 million. Now, we've been able to cover and recover the backlogs that we had in Q2 during the third quarter and also supported our revenue development going forward.

So, I don't think – there has been complexity to operate during the third quarter in terms of the lockdowns and related complexities, but nothing else than that. And I don't know how much more I would comment on that. So, some tens of millions of extra costs and the rest is the price/cost ratio that is impacting the profitability.

Guillermo Peigneux-Lojo
Analyst, UBS AG (London Branch)

Q

Got it. Very helpful. Thank you.

Operator: Next question comes from the line of Rizk Maidi from Jefferies. Please go ahead.

Rizk Maidi
Analyst, Jefferies International Ltd.

Q

Yes. Hi. Thanks for taking the questions. I'll start with the first one. So, Henrik, you sounded [ph] at update (00:49:09) more positive on modernization from Q4. And then, on the new construction side of things, a little bit more positive on completions rate next year. What gives you this confidence? I mean, we just had [ph] the NPC (00:29:21) and, obviously, there was a lack of stimulus amount for this [ph] product target (00:49:24).

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

Well, what we are seeing in the market, we are more positive in China. And I think you're talking about China, about modernization, that's just what we see in the market at the moment. I'd say that these completions, we are not seeing – well, we can see that the trend in completions is somewhat better than the one for new starts, for example. And then we know that the need to complete many of the apartments, particularly housing that has been started already and consumers have paid a down payment, that need is high. And therefore, we would expect – and that seems to be a lot of expectation in China that there needs to be an acceleration of completing the delayed buildings. We are not seeing that quite yet, but we said that that's something we would expect to start happening during next year at some point. When? We have to see.

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

And maybe to add to that, in one – still on amortization slide, we continue to see very good growth opportunities. But if you think about the size of the market, it's still a very small part of the total market.

Rizk Maidi
Analyst, Jefferies International Ltd.

Q

Understood. The second one is, are you concerned about sort of the pricing development in China now that cost inflation in the country are [indiscernible] (00:50:38)?

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

I would say, when we look at our own cost actions and we see that also material costs are coming down, clearly, the picture is better right now than it was, for example, three, four months ago.

Rizk Maidi
Analyst, Jefferies International Ltd.

Q

And just finally, just a clarification. Ilkka, you talked about a €400 million cumulative cost inflation and you said half of that sort of reverts? Maybe you can just come back to that point? Is there just some – the Asian sort of part of the compensation or think – how we should think about that cost element? Thank you.

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

I guess the €400 million is just adding on what the cost inflation was on previous year and then this year. And it is really related to the material costs, as well as our semiconductor total cost, including the spot price and, especially on the previous year, logistics cost was a part of that. So, that's the €400 million. And I wasn't very clear on commenting how much exactly we've covered, but rather was asked about somebody else's estimate.

Rizk Maidi
Analyst, Jefferies International Ltd.

Q

Okay. Thanks.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

Thank you.

Operator: The next question comes from the line of Andrew Wilson from JPMorgan. Please go ahead.

Andrew Wilson
Analyst, JPMorgan Securities Plc

Q

Hi. Good afternoon. Thanks for taking my questions. I've got two on strategy, so I guess that counts as one with a follow-up.

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

Yes.

Andrew Wilson
Analyst, JPMorgan Securities Plc

Q

In terms of China, are you able to give some helpful comments in terms of giving a bit of an understanding, at least into thought process on next year. I just – if you'd kind of comment on your sort of strategic thinking from a KONE perspective and whether anything that you've seen in the last, I guess, sort of 12 to 18 months has kind of changed that thinking, whether that be organically what you're doing in China but also just thinking a little bit of around these previously thought about potential to move [ph] through some sort of (00:52:50) bolt-on M&A in China and the potential that that might have on the service side? I'm just interested, I guess, high level on your thinking on China and your kind of position here?

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

So, our strategy in China is, of course – continues to be stable. It's clear that we have ambitions to be a very strong player in new equipment market, and we continue to have a very good business there. Even though we can see the market is lower, we continue to have a good business in China. But it's clear that our strategy in China is very much focused at, going forward, we want to drive a big part of the growth from services.

That hasn't changed at all, and we continue to see that as an attractive market going forward. So, I would say, fundamentally, when it comes to China, yes, we're trying – operating even more in China for China. But that's not the huge change to the past, but driving really the service business growth and continuing to keep a very strong position in the new equipment business.

Andrew Wilson
Analyst, JPMorgan Securities Plc

Q

Thank you. Then maybe to – onto the Connected Services side where I think the numbers – you've obviously [ph] helped with it today (00:54:03), I guess, the rate of acceleration there seems as if it's probably [indiscernible] (00:54:09) on the upside, but we will see. I guess, [audio gap] (00:54:14) a little bit about what you're seeing in terms of market dynamics. I'm interested if you're seeing – and you mentioned about the third party – whether you're beginning to reverse some of the trends with regard to the independent service providers and just from a kind of market share and feedback from customers to sort of [audio gap] (00:54:29) from there?

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

I would say, when we look at Europe, we look at North America, and many of the Asian markets, we are seeing that we are improving our retention rates. We are doing that in general but, in particular, with – when we have connected units. And that means that I think we are able to fend off better competition from the small independents, which have a more of a struggle to keep up with the technological advancement. But it's clear that also the small independents, they continue to have a role in the, I would say, standard residential older equipment. That's where they usually play.

But I think what we've been focusing on is that we can connect any brand. So, if the customer comes to us with a portfolio that usually then will have multiple brands, we can connect the whole portfolio, and not only the KONE units. And I think that's quite a unique thing in the market still today. And that is, of course, helping us overall on retention, I don't know anything more you would say about that, Ilkka.

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

Maybe I would expand to cover also DX Class elevators. So, if that was 24/7 Connected Services is available to a wider base. But then, when we talk about the DX Class elevators that we launched a bit more than a year ago, there, clearly I would expect the retention to be much higher than we've seen in the past and a future upgradeability through cloud connectivity and all the services that are then in future also available for those units. So, let's say, it's too early to say what the retention yet is because it's been launched relatively recently. But clearly, there's a lot of potential there to drive further improvement in retention for those units.

Andrew Wilson
Analyst, JPMorgan Securities Plc

Q

Yeah. Thank you for the help.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

Thank you.

Operator: The next question comes from the line of Panu Laitinmäki from Danske Bank. Please go ahead.

Panu Laitinmäki
Analyst, Danske Bank A/S (Finland)

Q

Yes. Thank you. I just wanted to ask about your order book. Can you comment how much of that is in China? And out of the China order book, can you comment how much is due to be delivered in 2023?

[audio gap] (00:56:45-00:56:59)

Q

New equipment ex-China and new equipment in China, my assumption is that, in that order, they have seen the greatest improvements, i.e., led by modernization and, specifically, I wonder whether you could tell us whether [ph] orders to margins in (00:57:16) equipment business in China has improved over that period?

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

Well, as I already said in our comments earlier, so in modernization business, we now have been able to increase prices enough to cover the cost increases. So, by – that is by far, from a business perspective, the recovery has been the best there. Then, in new equipment business, there are – outside of China, we've seen best performance from a margin recovery perspective in North America followed by Asia-Pacific excluding China, then Europe a bit more mixed performance there. But that's the one way to think about it.

Then, when you [ph] forecast (00:58:12) that to our sales, naturally North America has the slowest rotating order book, so it will take some time to get that to sales. Then, in China, so clearly what we've said and it continues to be the case that where's the pricing year-on-year – sorry, year-to-date is down. We had improvement in third quarter, but year-to-date is down. We've seen actually product cost improvements be a much bigger part of the recovery in margins. And we've seen 3 times maybe higher product cost reductions that we've seen in the past. And now, when we look at the raw materials, they start to be also a tailwind contributing positively to the margins. So, a bit different dynamics as such.

Q

Thank you, Ilkka. Maybe slightly bigger picture, if I can. Just on modernization, I think one of the interesting developments over last couple of years is the contraction in modernization margins, not just for you but for the industry as a whole, I think we have been near the new equipment margin in modernization.

I appreciate you don't get the standardization benefit in modernization as you do in new equipment, and clearly there's also been some raw mat headwind. But is there an element of, should we say, the digital service opportunity that comes with modernization projects driving more competitive pricing in modernization or can you give a bit of color, please, around that sort of development in modernization margins over the last couple of years?

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

Henrik had a flutter of strong reactions. Maybe you want to add there.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

I don't know where you have got this, that modernization margins would have declined over past years. Yes, they have had a temporary decline because of increased costs. But as Ilkka said, we have recovered that. Actually, structurally, modernization margins, if we look, are in, compared to other business, in better shape now than in a few years back. And maybe that's how we developed the business and improved and been able to standardize some of it even more, even though it can be quite different in different projects. But I would say that the trajectory of margins there overall, compared to, for example, new equipment, is clearly positive and now going the right direction as well.

Q

Thank you both.

Operator: Next question comes from the line of Tomi Railo from DNB. Please go ahead.

Tomi Railo
Analyst, DNB Bank ASA (United Kingdom)

Q

Hi, Henrik, Ilkka. This is Tomi from DNB. I'm also asking a question of the Chinese new equipment margins. So, if you could compare, Ilkka, or comment the Chinese new equipment margin compared to the group margin at the moment, and if it's fair to assume that it recovers to enhance or dilute the group profitability next year?

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

Well, if I look at our China business, it is contributing to our margins positively. And if you look at the past, clearly, it was a higher margin business. It has come down, but it's still contributing positively to our margins. Then, for next year, let's come back to that later.

Tomi Railo
Analyst, DNB Bank ASA (United Kingdom)

Q

Just a follow-up. Is that commenting in the maintenance or is that for the new equipment?

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

I made my comment in totality. Given this year, it's – actually, if you think about Q2, it's very extraordinary period. So, trying to annualize the business as totality is somewhat difficult in this environment.

Tomi Railo
Analyst, DNB Bank ASA (United Kingdom)

Q

Understand. Thanks.

Operator: And the next question comes from the line of Martin Flueckiger from Kepler Cheuvreux. Please go ahead.

Martin Flueckiger
Analyst, Kepler Cheuvreux SA (Switzerland)

Q

Good afternoon, gentlemen of KONE. Thanks for taking my question. First one is on Americas, for a change. Just wondering what your order backlog looks like in the Americas these days and what we can expect in terms of deliveries in over the next 12 to 15 months? That would be my first question.

And then, the second one is on your KONE's year-to-date pricing in orders received. This – if I remember correctly, one of your competitors very recently gave some indications on their order intake pricing. I was wondering whether we could get some granularity from yourself as well? Thanks.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

US order backlog is great. And so, there's a lot to deliver over the next two to three years there. So, we have a very strong position there. We have clearly gained market share in North America, so that'll be going from a good situation. Challenge in North America is that still, early this year, we expected more deliveries this year but we can clearly see there slowdown in construction site progress mainly due to labor availability. So, still projects want to go forward but labor shortage. And pricing, clear and good price increases in new equipment across the world. We haven't or we won't [indiscernible] (01:04:02)...

Ilkka Hara
Chief Financial Officer, Kone Oyj

A

We haven't specified in more detail, but clearly we've seen now since last year's third quarter pricing improving across the markets. And now, in third quarter, in all markets at the same time.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

And it's very clear, the improvement. So, good, good percentages.

Martin Flueckiger
Analyst, Kepler Cheuvreux SA (Switzerland)

Q

Great. Thanks.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

A

All right.

Operator: That is all the time we have for questions. So, I will now have a call back to your host with some closing remarks.

Natalia Valtasaari
Head-Investor Relations, Kone Oyj

Excellent. Thank you. Thank you for the questions and for the very active discussions. If you do have any follow-ups, please do reach out to me or the team. We're happy to help you. Thanks to everybody who's listened in as well. I hope this has been informative and interesting, and I'd like to wish you all a great rest of the day.

Henrik Georg Fredrik Ehrnrooth
President, Chief Executive Officer & Member-Executive Board, Kone Oyj

Thank you all.

Ilkka Hara
Chief Financial Officer, Kone Oyj

Thank you.