KONE Q3 2021 Interim Report for January-September 2021

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Natalia Valtasaari: Welcome KONE's third quarter earnings call. My name is Natalia Valtasaari. I'm Head of Investor Relations here at KONE. And I'm joined here today by Henrik Ehrnrooth our President and CEO and Ilkka Hara our CFO. As usual, Henrik will start by talking about the third quarter highlights, both business and financial. Ilkka will then dive deeply or a bit more deeply into the financials, and Henrik will follow that up with the business outlook and market outlook, and then we'll be ready to take your questions. But with that, I will let Henrik take over.

Henrik Ehrnrooth: Thank you, Natalia, and a warm welcome also from my side to our Q3 webcast. We all know that the external environment has many aspects right now, but what I'm very happy about is that in this environment, we've been able to find good growth opportunities and actually performed very well in this environment. Some of the highlights really of the quarter, where we had really strong growth in orders received and also a maintenance business developed very nicely sales was now more or less stable.

We all know that the global supply chain environment is very challenging and our focus in this has been really to focus on customer deliveries to ensure that we meet our promises to our customers. And I'm actually very proud to say that we have been able to meet our customer's needs throughout the quarter in a tough environment. And that is really the priority that we have had.

We all know that it's focus for us to deliver more value to our customers, to focus on value-added solutions. And in the quarter, we had a very important milestone, which was that our 24/7 connected services is now installed in 10% of our maintenance base. And those are customers who are commercially paying for the service. So continued very strong momentum there. And actually, momentum has constantly improved so we can see that we are really going in a nice direction here.

Now, let me start with some of our key figures. As I mentioned already, our growth was very good in the quarter that I'm happy about. Although our EBIT was impacted by increasing costs throughout the supply chain. Orders received are 2.2 billion, almost 11% growth in comparable currencies. This is a very good growth in this environment. Our order book at a very solid level of 8.4 billion and 3% growth, and that, of course, give us a good situation going forward.

Our sales was now 2.6 billion euros, 1% growth reported and in comparable minus 1.3, big differences here between new equipment and services. So new equipment declined somewhat, whereas very good growth, typically in maintenance. Operating income down 2% to 326 and a half million and adjusted EBIT – and actually EBITDA adjusted EBIT is exactly the same this quarter, declined from 340 million to 326.5 and a margin declined from 13.1 to 12.5%. Actually, given the headwinds we have, this is a very strong result.

Cash flow was very solid at 365 million. Yes, it's a decline from the exceptionally high level we had of 600 million last year, but this 365 continues to be a good cash conversion and 50 cents per share in EPS in the quarter. As we always say, one quarter is a very short period of time. And now we have of course, three quarters behind us. So a little bit longer perspective. And we have had a very robust performance in the first nine months, of course, because of very strong performance in the first half, particularly second quarter.

So orders received for the first nine months of about 6.7 billion and about 10% growth year over year. Sales of 7.7 billion, which is 6.6% growth year over year. So a good growth here as well. Operating income grown from 846 to 943 million and adjusted EBIT from 870 million to 950. And also here an EBTI improvement, EBIT margin improvement from 11.9 to 12.3 if we look at the first nine months, and of course mainly due to good margin expansion in Q2. Very good cash flow for the first nine months, a little bit lower than the exceptionally high last year by 1.3

million, very good cash conversion. And also earnings per share up 12 and a half percent to 143.

Now, as I mentioned already, we know that the global supply situation remains challenging. And as I mentioned, our focus has been to deliver on our customer promises and I'm very proud of the work our team has done, exceptionally good work to ensure that we have constantly met our customer's needs and being able to fulfill their demand. That has been a good achievement and I'm very happy about, and our team has again done an outstanding job in a very challenging environment.

So again very, very happy with what everyone at KONE has done, a huge, huge thank you to them. Talking about the global supply chain situation. We know that there are three main aspects happening. We have material prices, we have semiconductors, and we have logistics. We can say the material prices such as steel, that's kind of happening all the time. There sometimes going up, sometimes down, but that's kind of a normal business over. However, what I would say is what is different now is that all input costs are increasing steel, plastics, timber, everything, and that is just causing a big, big headwind. And the magnitude of the increase are very significant.

But then what perhaps a bit more unusual, something we haven't seen before are shortages of semiconductors. And then of course logistics costs because of capacity in the global logistics chain. We have been able to secure enough components to meet our customer demand, but of course securing those components in the market, in spot market means that the cost have increased. But as I said, focus has been on customer deliveries and that has worked very well. Same thing with logistics. We have been able to manage our logistics, but the cost of course being high.

So the additional costs in net basis, just from component semiconductors and logistics in the quarter is about 30 million and from all of these three aspects, materials, components, and logistics about 75 million on a net basis in the quarter. We have had a very good progress in reducing product cost, for example. So we have been able to compensate about half of the steel and other material headwinds that we have faced, but of course, still, a lot more needs to be done. So progress has clearly been better than usual years, but of course, much more needs to be done.

So what are we focused on? Clearly, how can we constantly reduce the product costs and improve our productivity? We have some actually very good progress here, and I'm actually optimistic that by the end of next year, we will have a lot of progress here. Pricing actions throughout our business. And what I'm happy to see is that actually we see good momentum price increases in many parts of the world, not all parts, but in many parts of the world and many businesses, it's clear that this needs to continue. And we just at the start of it, but the direction is definitely the right one.

Perhaps, what has been little bit more challenging than expected is China, but the rest of the world has been better. And then of course, as we talked a lot about a big focus area for us is our value-added solutions because that really improves the value to our customers and also improves our growth rate, both in our new equipment, but particularly our services business, which is doing very much so right now.

And therefore we wanted to dive a little bit deeper again into a 24/7 connected services because our momentum has constantly improved in sales in this throughout the year. And when I talk about sales, we talk about both what we sell it in connection with new equipment and service. And now what we about this penetration, we talk about how many units we actually have installed and customers paying for the service. And that's now reached 10% in the quarter at good pricing.

Another question is, of course, why are customers willing to pay a good price for the service? Well, because they have good value from it. It is an improved transparency for them. And we can also see a much better quality and productivity from our customer's perspective. What we can show now with the large set of data that we have, that we are reducing call-outs by more than 40%. That's very significant. We're also seeing that 70% of old faults we can identify proactively and we have reduced and entrapments in connected units by 50%. So we can see that these are not small numbers, it's actually very meaningful numbers. And that is something that's very much appreciated by our customers.

And also 24/7 has a good sustainability aspect. When we can plan better, we have less unplanned visits i.e., simply, we are driving less, which is a good thing. Secondly, these services enables us to improve the life cycle of products. When we add our 24/7 planner to our customers, we come with the data that we have collected and we see how their equipment is performing. And of course, with all the data we have about similar equipment. We can provide our customers now with long-term asset management plans based on very clear data.

And that has been usually a pain point for customers that very short term plans that they have got for many parts of how they maintain a building. Now we can have the plan several years ahead with this planner service, and that is something that also has good momentum because of the value and how it helps our customers manage their business much better than in the past. So overall, we know that this is our flagship digital service, and what I'm happy to say is that momentum continues to be strong and it's really contributing to our growth right now. So that's both KONE's development.

Let's then talk a little bit more about market development. And the good thing is that markets are recovering and that we can first see from just the number of starts in elevators. So how much people are using elevators around the world. We show now this data for several quarters for over a year, we started this during the pandemic. On the left-hand side, these are the same five countries we've tracked. And we can see that in each country, we're getting closer to a normalized level. We're not quite there, but it's getting in that direction and we can therefore also see that overall trends in the maintenance business are getting more normalized.

What is new data on the right-hand side is then when we look at, by segment, what is interesting to see is that when people are more at home, they're also moving more in and out of their home.

So actually residential elevators are used even more than pre-pandemic. And we can see that what is lagging is still offices, but still coming up. What is also interesting to see that in the Northern hemisphere, during the summer holiday period, actually hotel usage increased a lot. It is not at the same level where it's usually at during the holiday period but doing – because of domestic tourism, it really came nicely up and we could see that in our business as well.

And why we say that this data is indicative, there's actually quite a lot of data behind it. So when we look at it by country, there's about a hundred thousand connected elevators behind that data. And when we look at this by segment, that's more global the date and there's over 200,000 units from which we have collected this data. So it should show quite meaningful trends. And I think why this is important is that it shows that the maintenance business is more or less back. And when we look at our growth, we are actually also more or less back to a trend growth in that, but Ilkka will talk more about it a bit later.

So what about the new equipment markets? Well, perhaps the most positive development in the quarter was the North American market that grew actually stronger than we had expected. So very strong recovery in North America, United States in particular. Europe a bit less, and Africa, a bit more mixed continued recovery in central north Europe, although actually through the pandemic central north Europe was strong. So actually it's just continued growth, whereas more stable development in south Europe and a bit more challenging in middle east markets. So we're all pretty stable.

Asia Pacific, clearly two different situations. Asia Pacific, outside of China, very strong recovery. India, Australia, really leading that growth. And we can also see that Southeast Asia is coming back. China now in the quarter was more stable, but perhaps it's all the time important to put it in perspective, the China market. The China market is at a high level, remember the growth in the China market in Q3 and Q4 last year, we had incredibly strong growth on it in Q3 last year. So it's not that the market is low, the market is actually strong. And from here a little bit tempering now, as I will also talk about a bit later. So overall at the high level.

Service markets, broad-based growth in both maintenance and modernization. Maintenance continued good growth in Asia Pacific and slight growth in Europe, and east Africa, and North America, I would say, as in accordance with long-term trends. Perhaps the most positive market again here also was North America with significant and modernization and also Asia Pacific, both China and outside a very nice growth. So good opportunities in services overall. And that's, of course, the good aspect with the current markets.

So a little bit more in detail about the Chinese property markets. I know it's top of mind for a lot of people, of course, for us as well, very important market to us. So, as I mentioned, the market was pretty stable year over year, we signed some tempering activity. Although again, the market is at the high level. We are much higher than we were, for example, 2019 because of the recovery over the last year. Pricing environment continues to be tough, very intense competition, a lot of growth ambitions by many players. And overall we've done pretty well here. We've been able to have stable pricing in China.

If you look at the construction sector overall, you of course can see that the overall macro momentum in China is slowing. So it's having an impact. And we know that there's very strict regulation around the property sector and also both for supply and for demand and all it's really around liquidity. So very tight liquidity for developers. We all know about the three red lines policy, which is important, but also general more focus on that sector right now. And also for consumers, liquidity constraints for mortgages. What we've seen is that immediately, if any province has a little bit, or your city has little bit ease, these restrictions growth has come up quickly. So we can see the underlying demand is differently there.

Some of the statistics on Q3 you see real estate investments slightly down from a good level. The same thing with residential sales and new starts did come down now in the quarter. Pricing, slightly up. But we also put here to the right you can see if you look at year to date numbers, recovery has continued and actually quite strong, but 9Q3 clearly there's been more focus and we had a bit of a slowdown overall in the market from a high level. So that's a bit more detail about China.

And now I'll hand over to, Ilkka talk more about our financial development in Q3.

Ilkka Hara: Very good. And thank you, Henrik. And also a warm welcome on my behalf to this third quarter results webcast. And as normally, I'll go through the financials a bit more in detail, and I've also very good progress in number of areas to share it today. I'll start first with orders received. Orders received for the third quarter were 2 billion, 211 million. In a reported basis, that's 14.5% growth and our comparable currency is 10.9% growth. So very good growth across all businesses. So both new equipment as well as the modernization business, but what I'm especially pleased about that we saw also geographically broad-based growth in orders received. And particularly I would mention both Asia Pacific as well as North America, both growing well above 30%, their orders in the quarter. So very good progress there.

In China, our orders in monetary value grew slightly and in units clearly. As Hendrik already mentioned, pricing was stable in the quarter in China, whereas mix had a slight negative impact to our orders received. And therefore the difference between the value and volume. I talked about the growth in orders received, but also not only have we been able to grow, we've also seen positive development in our pricing.

Very pleased to see that pricing has continued to develop positively, especially in North America. In Europe, especially in central and north Europe, we've seen good progress. As already said, China was more stable and the competition was quite a tense there, but we continue to see the development that we start to mention already in second quarter to continue when it comes to pricing. But despite the pricing improvements, also the costs have increased as Henrik already mentioned, and therefore the margin of our orders received declined in the quarter due to the increasing costs, input costs, raw materials logistics, as well as semiconductors, as we already mentioned.

Into sales, sales for the quarter were 2 billion, 610 million roughly stable. On a reported basis, an increase of 0.9% and on a comparable basis, a decline of 1.3%. Geographically similar development. So Europe, Middle East, Africa declining by 1.2%. Asia Pacific including China declining 1.7% and America slight decline of 0.4%. New equipment contributed to this declines, modernization grew by 1%.

And what I would say that from a revenue perspective, clearly the highlight of the results was a very strong performance in maintenance. We saw maintenance growing now 7.5% revenues, and there the discretionary part of the revenue actually grew faster than that having a positive contribution. And overall, we are now broadly on the line of our normal growth if I look at the growth from 2019 for the maintenance business.

Adjusted EBIT for the quarter was 327 million, slight decline from last year's 340 million. The margin was 12.5 down from 13.1% of last year, but on a similar level than we had 2019 at 12.6. On the positive side, adjusted EBIT had a positive impact from favorable mix as well as a good development in services. Decline in volumes contributed to negatively both overall but also having a less fixed cost absorption there. But as Henrik already mentioned, we had a 75 million impact from increasing component and logistics cost. Having a negative impact to the results were partly able to counter that with actions, but not fully as visible in the results.

Into cash flow, cash flow for the quarter was 365 million. And as I always say, one quarter is a very short time to measure cash flow. So for the first nine months of the year, the cash flow was 1.3 billion. It was a solid number and we continue to see a positive networking capital of 178 million for the nine months contributing positive cash flow. And we continue to have a good cash generation for the business. So I'm very pleased on that.

Next, I'll hand over back to Henrik to talk about market and business outlook. Henrik.

Henrik Ehrnrooth: Thank you, Ilkka. So let's go into how we see rest of the year and start with markets. So new equipment markets in China, we expect new markets to grow clearly from a high level. And that's of course, because of the very strong activity in the first half of the year. Now Q3 was stable, Q4 probably slight decline. The rest of the world we can see a recovery in the markets from a lower comparison period. So that of course continues to provide good opportunities. Maintenance, we see a normalization in maintenance activity around the world and therefore, clear growth in Asia Pacific and growth also in rest of the world according to trends we've seen also pre-pandemic. And modernization expected to across all regions. So I would say overall quite a positive market backdrop for the end of the year.

And for KONE's business outlook, we have specified a little bit as we have now just a quarter left of the year. And we expect our sales to be in the range of four to 6% in comparable currencies. And we expect our adjusted EBIT margin to be in the range of 12.4 to 12.8%. We previously said 12.4 to 13%. Of course, assumes exchange rates don't change much from current level. There are many things that are driving good performance. We have very solid order book and as you see in our maintenance business and maintenance base performing very nicely. And what's been very good in the past couple of years has been our development in quality and productivity. So continuous improvements from there.

Then there are of course, things that are burning the result. We talked a lot about it, the main thing really the headwinds from materials, steel, and such logistics and electronic components about 200 million for the full year. So a little bit more than what we expected in connection with Q2 results. And then we've continued to invest in our capability to sell and deliver value-added and digital services. And as we can see, that is really paying off nicely.

But also as we are now entering the last quarter, we thought we were going to provide a glimpse into 2022. Of course, we'll come with much more clear guidance than in January next year, but a little bit what is it looking like going into next year? So many positives, we have a very solid order book as you saw at 8.4 billion. That is at a very good level. Our service business has a very good momentum, both in maintenance and modernization. So we're doing very well there and that's of course providing a nice boost and good growth and profitability to us.

And we can also see that with the visibility we have already now that the effects of product costs actions, but also pricing actions. They will start to have an impact in the second half of last year. Not yet in the first half, it takes a bit of time to have all of this in the market and pricing starting in the second half to have an impact. So that is going to drive performance then as well. But clearly, there are things that are burning the result that I think is pretty clear to everyone, the material price, raw material prices, steel, and such. As you remember, the impact was quite small in the first half of the year. So clearly there will be a carryover effect of the high prices going into next year. And the same thing for logistics costs and cost for securing electronic component availability.

The China market. As I mentioned, we expect the China market to be solid next year, although we expect it to decline somewhat from this year's high level. So we expect, still good demand in the market, although slightly lower. So that's what we mean with slightly lower visibility in the China market for next year. So they're both pluses and minuses and clearly a bigger impact of many of these negative things in H1 than H2.

And then to wrap up. So what is good is that market recovery is continuing despite the challenges in global supply chains. So demand is there. And we could see it across all of our businesses. We had very good growth in orders received and continuous market-leading growth in maintenance in particular, but of course, supply chain challenges will continue in this quarter and also in the next year. We are addressing this from a position of strength. We have a lot of capabilities and ability to address this, and we are doing it. Of course, we have a rock-solid situation to do it from, and we continue to drive differentiation with our value-added services and solutions that we see are starting to have a good impact on our growth in our business overall.

So with that, now happy to open up the lines for questions.

Operator: Thank you. Ladies and gentlemen, if you would like to ask a question, please signal by pressing star one on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, press star one, to ask a question. And we will take our first question from Andrew Wilson with JP Morgan. Please go ahead. Your line is open.

Andrew Wilson: Hi, good afternoon, everyone. Thank you for taking the time and for taking the question. I guess probably predictably I'd like to start on China, if possible, and apologies for that I'm sure. But if we take just your comment on China in 2022, Henrik is that a comment – talking about being slightly down [inaudible], is that a comment on new equipment or on the whole China franchise, so including the service components as well?

Henrik Ehrnrooth: Thanks. And Andrew, no reason to apologize to ask about China. Clearly, it's a high focus area for us as well. So when we talk about it, then I talk about the total market. What is the demand in the total market for elevators and escalators? So we expect that to be down somewhat next year, but still a solid market overall. Then of course our performance is a different question, of course we aim to perform as well as we can in that environment.

Andrew Wilson: And also to add to your comments. So we see good opportunities in modernization market to continue to grow as well as in the maintenance side of it. So it's the whole market, but we're not talking about new equipment only.

Henrik Ehrnrooth: Good addition. Thanks.

Andrew Wilson: Yeah. Okay. So I guess you can take that as the new equipment comment. In terms of the – and I guess this sort of links quite nicely to my second question, it seems that the outperformance from KONE versus the market in China was pretty evident in the Q3. Can you just talk about sort of what drove the outperformance, if there's anything you particularly flagged and I guess where do you think it can continue?

Henrik Ehrnrooth: One quarter is always a short period of time, and I think as you probably remember, we don't usually measure market share on a quarterly basis because it can fluctuate. We have a strong franchise in China. I think what is relevant is to see our longer-term progress in that market continues to be strong. And that is what is important. Of course, you need to perform every quarter, but we don't still think it makes sense to measure market share on a quarterly basis. We had – yeah, we did well overall.

Andrew Wilson: Okay. And maybe if I can just slide one final one in, just on the comments around the cost headwinds sort of flowing into to 2022. I don't know if you could kind of give us a preliminary idea look maybe on what that 2022 headwind might look like, obviously realizing it's more concentrated on the first half than the second half.

Henrik Ehrnrooth: Yes, you're right. So obviously, there's many moving parts still before we get to 2022 and we'll comment in more detail as we get to fourth quarter results. But just to give you an idea. So now the run rate of the headwind is around about 300 million. So 200 of that is now visible in this year. And therefore talking about something in the magnitude of over a hundred million next year mostly in the first half due to the lower comparison point.

Andrew Wilson: That's perfect. Thanks very much for the detail, guys.

Henrik Ehrnrooth: Thank you.

Operator: We will now take our next question from Klas Bergelind with Citi. Please go ahead. Your line is open.

Klas Bergelind: Thank you. Hi, Henrik and Ilkka. Klas at Citi. So first on pricing. So the market is obviously competitive in China and activity is now showing signs of leveling off. So I guess it's tricky to get positive price growth, but it should be very solid in North America and in parts of Europe. So my question really is, can those price increases be enough to offset the current cost headwinds in the beginning of next year? Obviously, you talk about the 100 million, Ilka first off weighted, or do you need to announce another cost program to keep margins going? Because something looks like quite a lot of pricing in developed markets relative to China to compensate. So, yeah, I will start there.

Henrik Ehrnrooth: Thanks, Klas. So I would say that it's clear that we are taking actions on many fronts, taking pricing actions. As I mentioned already that this year, we've been able to compensate about half of the gross impact from steel and material costs and things like that. So actually a very good performance there. And of course, we are driving that into next year. So it's both pricing, its product cost, its productivity, all of the above. So we are confident that we will definitely go back nice next year, but impact will start to happen more in the second half of the year.

Klas Bergelind: Okay. That's very clear. Second half of next year. Okay. Thank you. The second one I have is a maintenance growth, which came in better than I thought. Very, very good stuff here. How much of that is volume relative to pricing, to compensate for increased cost inflation, like inputs wage? I'm trying to understand whether this is an underlying improvement in maintenance activity. And if you could split the two in between discretionary coming back versus your digital efforts, start to kick in.

Henrik Ehrnrooth: Well, I would say that I wouldn't take the digital efforts as a separate item, but look at it more holistically. So it's way we do maintenance. We have a physical as well as a digital part of it. But from a unit volume perspective, we had a bit less than 4% growth in units and the rest is then pricing plus a bit of a recovery. Then we talked about the discretionary part, remember the 25% of the revenue. That grew around about 10%. So that's the kind of meat moving parts, but we see a positive impact from pricing through the 24/7. And also in this environment, we see good opportunities to continue increasing prices in maintenance, inflation helps there.

Klas Bergelind: So it's net pricing rather than just pricing passing on cost inflation? It's value add pricing that is contributing.

Henrik Ehrnrooth: Yes, exactly. So we see – so Henrik talked about the 10% penetration of the 24/7, and clearly, to me not only the volume has been the positive surprise. It actually has been that we continuously see good pricing development. So it's a stable development pricing, and that adds to our maintenance revenue then nicely

Klas Bergelind: Good. The third and final one is in [inaudible], you see a little bit slower growth relative to how you commented on the market last time outside north and central Europe. Is this supply bottleneck-driven construction projects being pushed out, lack of contractors and workers, or is there anything else? Is it demand-driven in any way?

Henrik Ehrnrooth: I would say that shortage of labor and materials and things like that can have a small impact, but not significant. I would say that those situations are still more anecdotal than broadly spread at the moment. I would say that it's perhaps more a demand-driven question. Some Southern European countries are doing okay, but it's a very mixed picture. Then perhaps a more challenging situation is in the middle east right now.

Klas Bergelind: Okay. Thank you.

Henrik Ehrnrooth: Thank you.

Operator: And we will now take the next question from James Moore with Redburn. Please go ahead. Your line is open.

James Moore: Yes. Good afternoon, everyone. Hi, Henrik, Ilkka. Thanks for the opportunity. I have one on China and one on the supply chain, if I can. On China, I don't know if you saw the ministry of housing rules out on two buildings. I wondered if you could help me size how important this is to you. And maybe what percentage of buildings are over these new rules of 150, 250 meters. And I'm thinking about mix effects, does a less super high rise help you or hurt you given density?

Henrik Ehrnrooth: That in itself doesn't have a huge impact. Of course, there had been a rule in place already of super tall buildings not being favored. And that the impact is actually not that big.

The vast majority of our business is the building is on 100, 150 meters. The standard residential you have there. So I don't – at least at the moment, I don't think that this is a big issue for us in particular.

James Moore: Thanks. And then on the supply chain, could you help us with some of the exposures to the new topics. I'm thinking about what is electronic components and annual freight as a percentage of sales and on freight. I guess the question at the moment is what is the split between land, air, and sea given the very different price inflations? And can you say, what share of freight is contract versus spot mix because we're in a situation where spot prices are super elevated, probably come down. The contract prices probably have to go up a lot. I'm wondering if you're already wearing that, or you have yet to wear that

Henrik Ehrnrooth: As much as I can say we are – of course, we try to do majority with contract prices. They're usually one-year contracts, those rolling and we have actually quite recently renewed ours. So don't worry, we are feeling the pain. So I can't say what is the split in total logistics cost between land, sea, and air, but the main impact is clearly on sea and we're starting to see now also that land freight cost, because as you see in many countries the lack of truck drivers is also driving up prices. So logistics overall is clearly a headwind and probably going to continue for a while.

James Moore: Maybe I could ask a different way, Henrik. This is a follow-up. Can you say what proportion of your global revenue goes on a boat?

Henrik Ehrnrooth: No, I can't. If you think about it, what is our biggest supply unit is in China there, 90% is for the local Chinese market. On the other hand, we are by far the largest exporters of elevators out of China. So we also have a big impact and a big share going abroad, but in the end, I would say pretty context that we are quite regional. But yeah, so I can't say.

Ilkka Hara: Maybe one way to think about it is, we're talking about maybe 150 million of costs on an annual basis in logistics. So it's not that huge of a number, either way, it goes.

Henrik Ehrnrooth: But this year it's become a bigger number.

Ilkka Hara: It's a bigger number clearly now this year, because of that.

James Moore: Is that the 150 that's going up to 75, or is that a wider bucket that's including the raw material, isn't it?

Henrik Ehrnrooth: No, the 150 is the annual spend on logistics, which is up now 40 million this year.

James Moore: That's very helpful. Thank you very much.

Operator: And we will not take a next question from Rizk Maidi with Jefferies. Please. Go ahead. Your line is open.

Rizk Maidi: Yes. Hi, Henrik, Ilkka. Thanks for taking the question. So I have two. So the first one is on supply chain, maybe, perhaps can you help us quantify what was the effect on EBIT in Q3 perhaps just as a headwind there. And also, how did it impact your different businesses? Did you have to prioritize maintenance and repair over new equipment or not in the quarter?

Henrik Ehrnrooth: I don't think we had to prioritize any business, but Ilkka could probably talk about this EBIT impact of this.

Ilkka Hara: Yeah. So as Henrik said first on this prioritization, so we've been actually able to deliver to customers quite well. So that's, I'm very pleased about, but I said it comes with a cost and for the quarter, this increase of raw materials logistics and semiconductors was roundabout 75 million. And we've been able to counter some of that with actions in this quarter but not all of it clearly. So our EBIT is down. And then at the same time, then we have the positives of growing business in services. And in particular, the good performance we had in maintenance contributing positively. And then for the quarter, we had a slight also a one-off item in terms of land sales, which was a bit more than 10 million but contributing positive to our results.

Rizk Maidi: Okay. Thank you. The other one is on the prolonged equipment lifetime on the connected services. Maybe can you give us a bit of data there? Like, how is that sort of improving in terms of sort of months, years, or anything you can give us there? That would be helpful. Thank you.

Henrik Ehrnrooth: I think we are quite at the start of this to have really hard data on this. What we've been able to show is that the asset management plans that we can provide based on these data are actually quite accurate. And therefore you can have good planning or what you need to upgrade and how are you going to maintain over the coming years? And that's why we are confident it will increase the lifecycle. That is something we need to wait a few years to have very specific data on to show that on a component level and total elevator level what the impact will be.

Rizk Maidi: Okay. Thank you.

Operator: And we will take a next question from Miguel Borrega with Exane BNP Paribas. Please go ahead. Your line is open.

Miguel Borrega: Hi, good afternoon, everyone. I've got two questions, please. The first one, just on cost inflation. I just wanted to understand the moving parts across the different segments, new installations compared to maintenance services. I know you don't break down the margins for each business, but directionally, would you be able to comment on how the margin for maintenance has evolved on a year-on-year basis would be fair to assume that margins are up?

Henrik Ehrnrooth: Well, from a margin perspective, the headwind that we talked about in terms of increasing costs is mainly impacting our new equipment and in the modernization business from a manufacturing point of view. Then in maintenance, we continue to see a good stable performance and the margins are developing in favour of EBIT, but clearly less variance there than in the equipment businesses.

Miguel Borrega: Okay. Great. And following up on that ballpark numbers, how much price increase do you need in new installations to stick and pass through those 200 million extra from cost inflation because if pricing in China remains competitive, I would assume that pricing needs to be materially up elsewhere in North America and Europe?

Henrik Ehrnrooth: Well, we have to remember that we said – we have three actions. It's about pricing. It's about product cost. And it's about productivity. So of course, it's a combination, all of this where you get to. I think it's very simple. You can take 200 million and we have a new equipment business that is in excess of 5 billion in total. But this year EBIT is over 10 billion in revenue is on new equipment a bit over half of that.

Miguel Borrega: That's great. Thank you. And maybe one last question on China, given the situation around liquidity, are you restricting in any way orders to some of your more distressed clients? Is there a more challenging environment around payment terms with developers that could be impacting your order growth or maybe even delivery? Thank you.

Henrik Ehrnrooth: Well, clearly we have and continue to be very tight with following up the credit risk we have with our customers. And I would have to say that if I look at a bit put things into perspective, we've actually been able to maintain a pretty steady payment terms in China, and especially given the pressure that we've seen now for the last year, year and a half. I think that's a very good outcome. And that's really then if we look at the results, one reason why revenue was down in China in the third quarter was that we've been very tight on not delivering unless we're comfortable that we get paid, and had the payments done according to our normal policies. So I think we've been doing a quite good job managing that risk in a right manner from my perspective.

Miguel Borrega: Thank you very much.

Henrik Ehrnrooth: Thank you.

Operator: And we will take the next question from Andre Kukhnin with Credit Suisse. Please go ahead. Your line is open.

Andre Kukhnin: Good afternoon. Thanks so much for taking my questions. Can I start with the revenue question on the new equipment? Sequentially, I think there's like a 200 million decline, which is very unusual from historic seasonality point of view. So I guess some of it is China, but looking at your disclosure, that's less than half of it. Could you talk about why we're missing that kind of 200 million of revenue in Q3 in new equipment?

Ilkka Hara: Well, it's a bit less than that, but in any case, we always have quarter on quarter fluctuations on the revenue and in this quarter it was a bit to down in new equipment and that's obviously is a function of the orders we get. And we've seen in some of the areas during the pandemic times orders being down at the same time then for example, in China, we've actually been having a good orders growth, but then also the sales growth has been quite good.

So there's less of a backlog there, but all in all, I would say that this is something, which fluctuates on a quarterly basis on new equipment. China you're right, it's down from sales perspective slightly, as I already said. And there, we've been quite tight with our payment terms, and that has impacted a bit the deliveries as well.

Henrik Ehrnrooth: Andre, also put it in perspective. Remember that, except for China, where in Q3 last year had tremendous orders as it grows, we had declined in other places. And it clearly that is something that then is coming through in the order book right now. So It's a very simple function of orders last year.

Andre Kukhnin: Got it. So should we take the Q3 then run rate as somewhat one-off compared to what you've been knowing and think more about maybe nine months run rate when we think about the rest of the year and going into 2022 for new equipment?

Ilkka Hara: Well, I think one way to think about it is that our order book is now up this quarter, and that provides us a good basis for growing our sales going forward as well.

Andre Kukhnin: Great. Thank you. And second question and sorry for being quite mechanical on this. But in terms of pricing feeding in as, I think you've mentioned that in China, my understanding is that you have raised prices as has done the industry from mid-year, but it's not really visible in Q3, as you said, your pricing is stable. Is it just a function of what you've been booking in Q3 was already bid for old prices or kind of, there's sort of a lifetime from announcing price increase to feeding in and hence, could you tell us what it is that like?

Ilkka Hara: Well, maybe I'll start, then Henrik if you want to comment thereafter. So first I don't believe in announcing price increases. Pricing is a function of the activity that we do with our customers in terms of selling, being able to be competitive case-by-case basis. And naturally now we've put much more focus on making sure that we are doing that in the right manner. And then the outcome is pricing.

What I said was that we saw already pricing improving quite nicely in North America, central and north Europe, particularly. And in China, it's been more stable. And that's the outcome of the activities that we've done. Naturally, everywhere in this environment, we want to make sure that we are maximizing the pricing on a customer-by-customer basis. But it's more the activity rather than an announcement that we do impacting there.

Henrik Ehrnrooth: Nothing to add.

Andre Kukhnin: Got it. Thank you. And last question, you mentioned -- you talked about 24/7 now being 10% of your maintenance base, which I think implies about 150,000 units and a bit of acceleration versus the run rate that you were at, I think for last couple of years. My notes suggest that you were about 100,000 units at the start of this year. So could you talk about the reasons behind that, is that higher kind of attachment rate on new service contracts that you sign? Or is it you going into existing maintenance base and signing customers up to 24/7? And maybe just in relation to that, could I ask how many total connected units you have at this stage?

Henrik Ehrnrooth: So first on 24/7 connected services, it's one of these things that – that is how we do maintenance and that is becoming more and more evident in our organization that, what we sell to our customers, a combination of digital and physical, and clearly the highest hit rates we have is when we convert new units into the maintenance base, but also what we can change contracts for existing contracts. So I think it's just something we built momentum constantly in the organization, building capabilities to sell them commercially, you really need to build the capability throughout the organization. That's what we've invested in.

And as I said before, why have we invested in, because this is the first really big service we have, but it's going to be more, and now we built up that capability, which is strategically incredibly important. If you just hand away these services, you don't build up that capability. And there, I would say that we have something quite unique in our industry right now. So it's just as simple, building up momentum doing well and also more and more evidence to our customers, that there are some clear benefits from them. Those are perhaps the most important things. What do we have total connected units with kind of old style connectivity and this about –

Ilkka Hara: 500,000?

Henrik Ehrnrooth: About half a million. Yeah.

Andre Kukhnin: Great. Thank you very much for your time.

Henrik Ehrnrooth: Thank you.

Operator: And we will now take our next question from Guillermo Peigneux with UBS. Please go ahead. Your line is open.

Guillermo Peigneux: Thank you, Henrik. And thank you, Ilkka for your time today. I wanted to ask two questions. First on your slightly lower China comments. So when I go back to your performance and market share gains actually throughout the history of China, I think there is a period between 2015 and 2017 in which you do have more or less, anything between low single to meeting will be declined in the market. But it took a number of years, would you characterize the situation that we do have at this point in time similar to that one? That is my first question.

Henrik Ehrnrooth: Exactly how the market would develop over the coming years will be a lot policy-driven. We think urbanization is continuing and all that. What is perhaps slightly different is that if we go back to the situation kind of 2015 to 2017, which was, again, a more difficult situation is that, when we went into it, remember 2015 particularly, we had extraordinary high margins in China. And actually, the whole industry was very profitable. Market came down and actually created competition so margins came down, but we ended up back with margins at very good level, but I would say from exceptional levels.

If I look at the profitability today of the players in China, both domestic and international, profitability is not that high for many players anymore. And I think many of particular mid-sized players are struggling to make money. And therefore, I think the pricing situation is probably going to be different now because you had a double whammy. Then you had both a market as came down and pricing that came down. But frankly, I don't see how pricing in this environment is going to be able to – people are going to be able to survive if prices come down.
As I said, we are a few of us have good margins. I think we are probably one of the leaders there. So I think that's perhaps the biggest difference. How is the market going to develop over five-year period? That is of course too early to say, only thing we can see that, what are the key trends in China? Clearly, a lot of rebuilding that is very important. That's a big parts of

the market already now. Rebuilding buildings that might not fit for purpose of high enough of a quality and then continued urbanization, particularly in the three mega cluster areas. So I think that there are many good things, but of course, as we all know, it's going to be very policy-driven how markets will develop.

Guillermo Peigneux: Thank you. And the second question and I think you alluded to it from a market perspective, but I wanted to risk a question on your KONE's perspective as well. I think coming into the 2015-17 cycle your margins, I think were around about 20% in China for new equipment. Then obviously, after the market did erode for a little bit, your margins also went down a little bit if I'm – correct me if I'm wrong, of course. And then obviously they have recovered, but I wanted to – before going into 2022, I wanted to address a little bit the trajectory of the margins from a new equipment perspective of KONE in 2020 during the first half of 2021 just going into, I guess basically 2022.

Ilkka Hara: But a correct trajectory last year, particularly was a good one. Of course, the first quarter was not good because everything was shut down. But from second quarter onwards, we had actually very good trajectory then costs started to come up significantly from kind of mid this year. And that started to have an impact maybe sometime May or so was kind of the shift.

Guillermo Peigneux: Exactly. And can I risk maybe, are we in mid-teams level as we speak, or is it somewhat below those levels in 3Q?

Ilkka Hara: What I would say is that we continue to have a good business in China that contributes positively to our EBIT margin, but we haven't been very particular on the exact margin.

Guillermo Peigneux: Thank you. I needed to ask. Thank you.

Ilkka Hara: Okay.

Operator: And we will take the next question from Lucie Carrier with Morgan Stanley. Please go ahead. Your line is open.

Lucie Carrier: Good afternoon, gentlemen. Thanks for taking my question. I have a couple of follow up. Ilkka, you've mentioned the backlog being quite strong. It's up 3% organically year on year. But it sounds that when you talk about the market, particularly in China, where you've had very strong order intake, the last 18 months, you sound a little bit more cautious. So my question, I guess is, shouldn’t the backlog be something that should nicely carry the activity in China, at least for the first half of 2022 considering where we stand now? Or should we think anything differently or what are you concerned around maybe materializing this backlog?

Ilkka Hara: From an order book rotation point of view, less worries. We have good quality orders, and we haven't seen cancellations in the orders in the order book. And then that gives us a good basis for next year. We'll will come back to the sales guidance for next year closer to the fourth quarter.

Lucie Carrier: Okay. So you're not concerned by any delay or kind of retaining some of the contracts because of credit policy and so on that you may have internally.

Ilkka Hara: Well, there's two separate questions to that. One from orders quality, we haven't seen any problems with that. Orders cancellations are very normal, so no change there. Then the order book rotation, we continue to work with our customers. The third quarter, we did have an impact from the liquidity situation. So we saw some of the customers slowing down their progress. Let's see how that develops going forward with our customers.

Lucie Carrier: Thank you very much. My second question is still on China, some of your competitors have mentioned kind of an initiative to improve their reach of the Chinese market not to be lower tier cities adding some distributors, salespeople, and so on. My question was, can you maybe help us understand how the business works with the distributors, particularly, which I think is still a large chunk of what you do in China. How well ae those distributors incentivized to work with you rather than maybe working with another manufacturer?

Ilkka Hara: Who wouldn't want to work with KONE? Maybe that's my subjective point of view here, but now of course, you need to have – of course, a distributor will look at, "Okay, what makes them successful?" Of course, you have long-term relationships you have developed with them they understand your offering and all of that. So it's all of those. You need to constantly be competitive and together with them win in the market. That makes both of you successful. And that's as any business is the essence of business and I think we have a good situation here. I think we have a reach in China that is probably second to none and very loyal set of sales channels for us in China. So I think that's a good situation that we have. Clearly there are others who are trying to copy that. And that of course is understandable.

Lucie Carrier: Okay. Thank you very much.

Ilkka Hara: Thank you.

Operator: And we will now take our next question from Joel Spungin with Berenberg. Please go ahead. Your line is open.

Joel Spungin: Yeah. Good afternoon. Just a couple of questions. Maybe if I can start on modernization, and obviously I'm just curious to know, obviously, you grew 1% constant currency in the third quarter in modernization probably a little bit less than I was expecting, certainly. Is there any specific issues that you're encountering in terms of the modernization business, either in terms of delays to orders being executed or anything like that? And do you think that this is still a market that has space to recover as we move into 2022?

Henrik Ehrnrooth: Absolutely. It has space to recover and as you saw in our outlook, we expect the market to continue to recover. I think this is mainly we talk about the order book rotation, question of late last year what the orders we took in, and so forth. I don't see that there would be any constraints of executing. You have to remember the modernization business very often is very much up to us and our customer when it's done as an existing building.

Ilkka Hara: Maybe the only thing to add there would be that during last year, modernization was impacted by pandemic. The decisions were slower. Now this year, we've actually now orders have grown quite nicely, so that gives us a good basis going forward.

Henrik Ehrnrooth: Yeah.

Joel Spungin: Okay. So it's predominantly a timing effect rather than anything else at this stage.

Ilkka Hara: Yeah.

Henrik Ehrnrooth: Of course, it is.

Joel Spungin: Okay. Thank you. Then maybe just one more on China. I was wondering maybe – I'm sure you're not going to name names, but just in terms of the risk in the China business from specific developers. Are you able to maybe put into context what your exposure either directly or indirectly to developers who are in breach of the three red lines currently? Is that something you have to hand?

Ilkka Hara: Maybe I'll take that. So first to put things to context, even though we talk a lot about how the market in China consolidates. So it's still, this is an industry where customers are quite fragmented. So even the biggest customers that we have are a bit more than 1% in global turnover. So quite a fragmented customer base. Then when it comes to the exposure to these three red line policies, the customers that are breaking more than two red lines, we're talking about maybe four, four and a half percent in turnover.

Joel Spungin: In that case, thank you very much. Chinese turnover. Okay. Thank you.

Ilkka Hara: Yeah.

Operator: And we will now take the next question from Daniel Gleim with Stifel. Please go ahead. Your line is open.

Daniel Gleim: Yes. Thank you very much for taking my questions. Actually, the first one would be the separation in between you tightening payment terms in China and your customers from there and slowing construction. Could you please scale for us, which one was the more relevant part in the third quarter?

Henrik Ehrnrooth: Ilkka, I don't know if we tightened our payment terms. I think we held on to good payment terms.

Ilkka Hara: Yeah, exactly. So we haven't changed them, but we've kept them on a good level as we've had in the past. Then in some cases that has meant that we haven't delivered to site, unless we are comfortable with the payments that they have to make before we deliver it to site.

Daniel Gleim: And if you contrast between yourself proactively affecting execution, and on the other hand, your customer holding back execution, which one was the stronger driver in the third quarter?

Henrik Ehrnrooth: That's hard to say. I think a bit of both, and sometimes it's hard to actually differentiate which one it is

Daniel Gleim: When you think about large developer consolidation, what is your assessment how the changes in regulation are going to affect those?

Henrik Ehrnrooth: We can see that – it's a mixed picture there. Some of the large developers have very good situation. Some of them have a more challenging situation, but so is it also with the ones below them. We expect still that in this market, it's the big developers. And when we talk about the big, then we talk about the top 50, even top 100 in China that are probably the ones who have better ability to grow, we think. It's going to be important to have good relationships with those customers.

Ilkka Hara: And maybe also another perspective the same topic is, this three red line policy was announced middle of last summer. Initially, it was targeted to this. A dozen companies are now broadened to cover 20. So what we've seen as a result actually is that is having an impact. So we see companies actually delivering and actually being in a healthier position when it comes to this red line. So in that sense, it is actually helping the industry to going forward, as well have a healthy customer. So that's a positive sign. Then in individual cases, clearly we've seen a bit more difficulties as a result. But overall, I would say that it has had a positive impact to the industry.

Daniel Gleim Thank you for that color. On the slide for the 24/7 connected services, you mentioned 70% of all potential faults have been identified. I assume you're moving along the learning curve with more analytics and more data. You could probably drive this number higher. Have you already thought about what the probable ceiling or the target will be for the 70%?

Henrik Ehrnrooth: I can't say that, but you're right that we have all the time more and more data and I think that again shows why the big players have a big advantage here because we can all the time refine or what we call, how we create the service needs. I think where we can get more and more better all the time is that, which one do you actually react to and which one you don't have to react to and all of that to even improve also productivity.

So I think 70% is already at the very good level. And frankly, I don't know what the ceiling could be. I'm sure it can go somewhat higher, but clearly, there's going to be faults that you can't identify. But the good thing is that also in those situations, now we are connected. We can find out immediately. We actually even know usually before our customers notice it so we can fix it quicker. So I think it's a combination of those two, but of course, we learn every day.

Daniel Gleim: Very clear. Thank you both.

Henrik Ehrnrooth: Thank you.

Ilkka Hara: Thank you.

Operator: And we will now take the next question from Tomi Railo with the DNB. Please go ahead. Your line is open.

Tomi Railo: Hi, this is Tomi from DNB. On China, I was wondering if you could comment monthly development in the Chinese elevator market July, August, September. How did you see the markets developing during the quarter monthly and maybe how has October started?

Henrik Ehrnrooth: We don't comment on orders within a quarter. But of course we can see there's some impact on the market, but at the same time, the market is there, but there's some impacts but we don't comment on month to month orders. They can fluctuate the fair bits, of course.

Tomi Railo: But in terms of the market, did you sort of – would it be fair to assume that the Q1 was maybe still strong, then you started to see a weakening towards the end of the quarter in the marketplace?

Henrik Ehrnrooth: If you look at even the holidays impact the market activity. So I think it's – going to that level of detail, to me, it doesn't make sense. I think market continues to be there, as we said earlier in the market and maybe in fourth quarter, then a more stable development there. So nothing too particular to mention there in my mind.

Tomi Railo: Okay. Thank you.

Henrik Ehrnrooth: Thank you.

Operator: And that concludes today's question and answer session. At this time, I would like to turn the conference back to our speakers for any additional or closing remarks.

Henrik Ehrnrooth: All right. Well, thank you all for joining, and thank you for asking questions, just perhaps a few things to wrap up before I hand over to Natalia. What is important to keep in perspective is that the markets are currently good. Recovery is there both in new equipment, in many parts of the world, and in services. And as you saw, we've been able to in all businesses capture those growth opportunities very nicely. It is on the other hand clear also that the global supply situation with materials, components, logistics will remain challenging going into next year.

And of course, we're taking a lot of action. I think the visibility we have, we can see that both pricing, product cost, and so forth and productivity are having an impact. And it's clear that the impact is probably more going to be seen in the second half of next year, but the visibility is there. So from that perspective, I remain optimistic that we can also overcome these challenges in the midterm. So that's of course a good thing and yeah, growth is there. So with that, happy to hand over to Natalia to close the day.

Natalia Valtasaari: Thanks, Henrik. Thanks, Ilkka. And thanks to everyone on the lines both for tuning in and for the questions. If there are any follow-ups, please do reach out. We're here with the team to answer those. And with that, have a great day.