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Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

As usual, Henrik will begin by taking you through the key developments in the quarter, both in terms of our financial and business performance, but also what we're seeing in the markets. Ilkka then deep dive a bit into the financials, and Henrik will wrap up with our market outlook and our guidance for the year before we then move into the Q&A session.

During the Q&A session, I would ask you to limit yourselves to one question and one follow up so that we make sure as many people as possible have the time to go through their questions.

But with that, Henrik, please.

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

Thank you, Natalia, and good to have you all online. Our second quarter was clearly a mixed quarter. It ranged everywhere from significant impacts from COVID lockdowns in China to an excellent performance in our services business, so many different situations in the quarter. So, if we start with the highlights of Q2 2022, clearly the lockdowns in China had a significant impact on our deliveries, although our order development in China was robust, which is clearly a positive.

We again had an excellent quarter in our services business, and what is positive here is that the good growth in services overall was driven by both pricing as well as volume growth. So we are making good progress here again. Our actions to improve our profitability are progressing well and clearly remain a top priority. Ilkka will talk a little bit more about how we are progressing here.

So, some of the key figures for Q2 is that our orders received were just slightly up year-over-year in comparable currencies are just over €2.6 billion. I think the environment – in the environment I think it's actually quite a good number. Our order book is clearly at an all-time high at exactly €10 billion and that's up 12.2% year-over-year in comparable currencies. So clearly, that's very strong and gives us a good situation going forward from here. Sales are €2.55 billion, now down 15%. And clearly here, as we had announced already, impact from China was quite significant.

And given the impact of the COVID lockdowns, our operating income declined 48.5% to €189 million, and our adjusted EBIT declined by 44% to €209 million, giving us a margin of 8.2% compared to 13.3%. It is clear that this type of margin is not okay to us and it's clear that we want to improve it quite significantly.

Our cash flow €166.6 million down from the exceptionally strong level of over €500 million last year. As we always say, one quarter is a short period of time and now we have six months behind us, which gives us a little bit more perspective.

From orders received perspective in this type of environment, we grew now at a comparable rate at 5.2% to just over €5 billion, I think is actually quite a good number. Sales close to €5 billion as well, although down 8.5% and clearly was an impact from Q2. And also we can see here the significant impact on our EBIT and adjusted EBIT of what's happened in Q2, so EBITDA €360 million, adjusted EBIT from €624 million down to €406 million. And also here, 8.1% margin is clearly not enough for us.

And cash flow at €385 million, Q2 was a solid cash flow, now slightly lower. Ilkka will talk about more down from the really exceptionally high level of over €900 million last year. And earnings per share also down from €0.92 to €0.51 per share. It is clear that a lot of things have happened in the quarter and the first half of the year. Everything from COVID lockdowns in China, the war in Ukraine, disrupted supply chains, but at the same time, good opportunities in services in North America, many other markets.

So it's been a very changing environment and that, of course, takes a lot from the teams. And I must say that I think the KONE teams have done an outstanding job again in navigating this environment, finding opportunities, continue to drive improvement as we'll talk more about today. So a huge, huge thank you to everyone at KONE for that.

And we could see that employees of KONE are doing a great job and also they remain highly engaged. In the quarter, we again conducted our annual employee engagement survey and we can see that our employee engagement stayed at a good level. It was slightly down year-over-year, but it's clearly above where it was pre-pandemic level, clearly above outside benchmarks.

So overall, in this type of environment, with a lot of uncertainty in the world overall, we can see that engagement of our employees is high. And when we look at the overall survey, feedback is actually pretty good. So that, I'm incredibly happy about.

And we could also see the great work our employees are doing in the development of our Net Promoter Score. So in the quarter, we did our annual Net Promoter survey where we surveyed broadly our customers globally. And I'm happy to say that we had another good year of improvement. And what I'm particularly pleased about here is that we know that supply chains have been disrupted this year and there's been a lot of uncertainty. At the same time, our customers are giving a – us constantly better feedback on how we are delivering to them. So we had a broad-based improvement both in the services business, in the new equipment business, and through most geographic regions. So really, really a strong result here.

What is the feedback we're getting from our customers is that, they very much appreciate the quality of our products, overall our products, the quality of our services, how we serve in a relationship with KONE. And clearly, we have areas we can improve, for example, in customer communications and how we interact with them. But many things are moving forward and we can see this trend over many years has been quite positive. So I think these are two very, very fundamental topics and, of course, these are the first two strategic targets are about making KONE a great place to work, and have the most loyal customers. So therefore, these are really important and fundamental metrics to us. So that's something I'm definitely happy about.

So that's a little bit of highlights of what's been going on at KONE in Q1. Then what about the markets? So when I look at the new equipment markets, we again have two very different stories here. New equipment markets outside of China have actually been good. Clear growth in North America, growth also Europe, Middle East, and Africa, particularly South Europe, and then good growth in the Middle East. Although, we could see some impact of the war in Ukraine, demand in Central North Europe and perhaps the energy crisis having a little bit more of an impact there. But overall, growing markets.

Also in Asia Pacific outside of China, a significant growth in Asia Pacific outside of China, and here we really call out, for example, India, which you all know is a very important market for KONE, great development in that market. But then it's clear that China was significantly impacted by COVID-19 lockdowns and continued liquidity constraints on developers. So that means that the market did decline significantly. But I'll come back to that a little bit more in detail soon.

Services markets continue to develop very nicely. So this is a really – continued to be a good story. And maintenance, some growth in all of the mature markets and clear and good growth in Asia Pacific. Perhaps the most positive market overall is the modernization market right now with significant growth in both North America and Asia Pacific and also clear growth in Europe, Middle East, and Africa. So we've been putting a lot of efforts here. And I must say that our development or say modernization from product perspective has been – has been excellent. So a lot of great opportunities there.

And when we look at the fundamentals for the service (sic) [services] (00:09:09) business, this chart you've seen now throughout the pandemic from us. This is again the monthly average number of starts per elevator from a very broad base of connected units. What is positive is we can see that number of starts per elevator is more or less at pre-pandemic levels. So people are moving out and about. Yes, it differs a little bit by country and by segment, but by and large, back there.

And why do we follow this? Because this really tells about the longer term need for maintaining and upgrading elevators. And we definitely see that the need is there. So this is a great development, a good picture for us as well.

So little bit more about China. If you look at the property markets, first of all, as I mentioned, the big impacts have been liquidity constraints for developers and of course, COVID-19 lockdowns. So, the overall markets declined by more than 20% in Q2, and the pricing environment was very intense, there's no question about that.

So, the lockdowns had a negative impact on many markets and, of course, created uncertainty that I think is clear to everyone; however, we have started to see some easing measures, particularly from local governments to stimulate little bit the demand side from consumers. So actually, I'm not sure we call it stimulus, but they have reduced restrictions for buyers. Some, also improvement in liquidity, but not significant yet.

And what is the situation for KONE? So in April, there was several weeks when the City of Kunshan was in total lockdown, so it was impossible to keep the factory open. And then, we went to May, we had for a while so-called closed loop production, it was still a limited production, although in June, we were back to full capacity in our supply chains, both in Kunshan and Nanxun, both ourselves and our suppliers. So, we did recover pretty well from there.

Maintenance has been resilient. Of course, modernization has been impacted by same issues in the supply chain. So, that was clearly the big impact and our sales declined in China as a result of this, in total about 40% in this quarter.

But what I already mentioned is a positive thing is that there's been solid demand for KONE's solutions. If you look at the statistics for the real estate market, we can see that there are clearly challenges with real estate investments down, also residential sales volume and new starts. What is positive is that prices in 70 largest cities have been very stable. It is also clear that we are starting to see improvement in all of these numbers, and therefore, we are expecting a somewhat better second half than the first half in this perspective.

So that is about KONE's development markets. And now, I'll hand over to Ilkka to talk more about our financial development.

Ilkka Hara

Chief Financial Officer & Member-Executive Board, Kone Oyj

Thank you, Henrik and also welcome on my behalf to this webcast for second quarter results this year. I'll go through our financials in more detail and start with orders received development. Orders received for the quarter were SEK 2.609 billion. On a reported basis, there's a growth of 8.2%, and on a comparable basis, 0.6% growth in the quarter. I would say that this is robust considering the environment where we operate. We saw strong growth in Americas as well as in Europe, Middle East, Africa. And also Asia-Pacific, excluding China, grew strongly in the quarter. Naturally, China's impact then drew APAC as a whole to a decline.

Second, our actions around pricing, product cost aimed at our margins are progressing well. I'll come back to them a little bit later in my presentation in more detail. But as a result, we continue to see sequentially our orders received margin improving again. So starting from fourth quarter last year, we've now seen three quarters of improvement in the margins. At the same time we're still slightly down compared to last year's equivalent quarter in the margin.

Then to sales. Sales for the quarter were €2.555 billion, down on a reported basis 9.1% than our comparable basis, 15.2%. Americas grew its sales by 2%; Europe, Middle East, Africa came down slightly at 1.4%; and APAC overall declined by 31.5%, driven by the development in China where our sales declined close to 40%. In the rest of Asia-Pacific, we actually saw growth in our sales.

In business line-wise, new equipment was impacted by the China and declined 3.1%, but we continue to see very strong development in our services business led by the maintenance growing 7.6%. So, very good development there. Also, modernization were stable compared to last year at 0.5% down.

Then to adjusted EBIT, which for the quarter was €209 million, and the margin was 8.2%. While we did see the good development in services contributing positively to our growth of our adjusted EBIT, the decline in sales in China naturally had a negative impact overall. From a profitability perspective, we continue to see improved quality as well as productivity contributing positively. At the same time then in second quarter, the impact of increasing input costs was €70 million, covering the material component, the logistics costs. And then, naturally from a profitability perspective, having less sales, we had a lower fixed cost absorption as a result.

As already said by Henrik, this is not naturally a level where we're happy with. And as a result, we have very clear actions on how to improve our financial performance. We're driving pricing across all regions and businesses, and also implementing more dynamic contract models which are better suited for this highly volatile cost environment.

In pricing, we see very good progress in maintenance as well as in modernization, where we've been able to almost fully transfer to prices the increased costs. At the same time, in new equipment, our pricing develops positively when we look at Americas, Asia Pacific, as well as in Europe. And while we still have more work to be done to be able to fully offset the increase in costs, we progress well. In China, the pricing is clearly – it is more a challenging market from that perspective.

Then, the second action is around product cost. Actions in sourcing and our offering developments decreased the product cost. There, we continue to make good progress and we are seeing 2 times to 3 times higher product cost reductions that we normally see. And while the pricing environment in China is more challenging, there, we've been seeing then a better development from a product cost perspective, leading clearly globally the effort there. But also in other factories, we see good development from a product cost perspective.

These are the actions that are really about the orders that are coming in the new business. We also have an existing order book and we are focused on improving margins there. Clearly, driving productivity across the business is important. We've seen now for the first half of the year good development in productivity, actually better than we've seen in the past. So that's helping us then to counter some of the headwind that we have with existing orders going forward.

And last, clearly, we need to and we are accelerating the services business growth. For the first half, we have seen very good growth in the services business and maintenance especially as clearly one of the key actions to drive the improved financial performance going forward.

Then lastly, the cash flow. Cash flow for the quarter was €167 million. That's a down from what I would call an exceptionally high level in previous year second quarter. Operating income contributing to a decrease in cash flow, but also last year we had a very positive development from working capital point of view. Now, we actually see working capital coming – going up slightly.

And the key drivers for that are accounts payable. There we had exceptionally high level, I would say, on payables. Now it's more normalized. We have increased inventories given the environment where we are operating from a supply chain perspective. And then lastly, particularly now in the second quarter, we announced the divestment and suspension of our deliveries in our operations in Russia having also a negative impact to working capital as we are ramping down the equipment business there.

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

Henrik Georg Fredrik Ehrnrooth

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

Thank you, Ilkka. So to wrap up, new equipment markets for the full year this year, again two different stories. Chinese new equipment market, we expect to decline significantly this year due to a tighter liquidity situation for developers and, of course, COVID-19. What this means, we think the market's going be down about 15% for the full year year-on-year.

In the rest of the world, we expect that the activity will increase. So, good markets overall in rest of the world. Also modernization markets, we expect that they will continue to grow and be very solid. That's been definitely a positive in this industry. And maintenance markets really returning to pre-pandemic growth trajectory, which means slight growth in mature markets and good growth in Asia-Pacific. So, really what we've been seeing for a longer period of time.

Then our business outlook, which we announced already last week, we now expect our sales to be in the range from minus 1% to plus 3% in comparable currencies compared to last year. And we expect our adjusted EBIT to be in the range of €1.130 billion to €1.210 billion, and that assumes that foreign exchange rates stay about at the level where they are now.

Now, as usual, there are a number of things that are positive, driving our performance, the great outlook for our services business and the performance there, and our very solid and large order book. We also expect that the profit improvement actions that Ilkka talked about such as productivity, pricing, cost, and so forth will start to have a positive impact towards the latter part of the year.

Then, as we know, there are a bunch of things burdening our result, about €200 million headwind from materials, components, logistics, and so forth. What I would say here is that while the headwind continues to be very significant, that we're starting to see the first signs, I wouldn't say anything concrete, but first signs of improvement in global supply chains, overall logistics, and perhaps, component availability and so forth, still tight, but at least first signs of improvement. Clearly, also COVID-19 lockdowns have an impact and also the competitive dynamics and pricing in the China market are very challenging.

So to wrap up, great continued development in our services business that I'm very, very pleased about. It's clear that we have a very strong focus right now on delivery execution so that we can deliver on our large order book, which we're confident we can do, and securing our continued progress in our actions to improve our profitability. We have good momentum there, and that we want to continue.

Perhaps the most positive is that we have a high employee engagement that is absolutely fundamental in an environment like this. We have an improving customer loyalty. I think these are absolutely great positives in capturing opportunities going forward.

So with that, we are definitely ready for your questions.

QUESTION AND ANSWER SECTION

Operator: Of course, thank you. [Operator Instructions] And as a reminder, we ask that you only ask one question and one follow-up question. You may reenter the queue for any additional questions. [Operator Instructions] We'll go ahead and take our first question from Daniela Costa with Goldman Sachs. Please go ahead.

Daniela Costa
Analyst, Goldman Sachs International

Q

Hi. Good afternoon. Thank you so much for taking my question. I'll stick to one and then I will ask a follow-up afterwards. But I – I mean looking at your slide on China, it sounds like despite the market drop, you're still gaining market share there or at least I wanted to ask you to how do you read the fact that you're saying your units are only down 10%, the market's down more than 20%. Is it a market share gain from who or is it just where you're distributed in the country or any sort of mix impact, but how do you sort of phrase that difference?

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

A

Thank you, Daniela. I would say that, yes, we clearly had a very robust performance compared to the market. Again, I would highlight again as we said so many times that this is one quarter, a quarter there can be fluctuations. But it's clear that relative to the China market, I think we're performing well. I do think we are performing well.

We know many of the smaller players are challenged in this type of environment. So I cannot say really who we're taking market share from. Clearly, we have that, but that's – I'm not sure the most relevant point. But yes, we are performing well. We are doing well. But again, let's remember it's one quarter. But also if you look at the first half year performance has been pretty solid from that perspective.

Daniela Costa
Analyst, Goldman Sachs International

Q

And then my follow-up relates to Europe and US equipment margins. Given what you have said in past calls regarding your profitability on services not being too different from where one of your peers that discloses it is. And where you – what you've said in the past regarding China, I don't know if this is still true, but China not being below group margin at the moment. I'm not sure if this was true, but that looks like your Europe and US equipment margins must be very, very low or even breakeven. Can you talk about sort of, I know you don't comment on levels, but compared to history where we are there, and how much of potential raw material tailwind going into 2023 helps you normalize that to historical levels?

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

A

Yeah. Maybe, Ilkka, you start with that.

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Yeah. So, I would say that clearly, second quarter from equipment business perspective was heavily impacted by first, the COVID-related measures in China and volumes were lower than normally. And also, the cost levels have increased considerably, as we've said, about input costs. And that's mainly then impacting our new equipment business as such.

In – and your question around, then new equipment business outside of China, the profitability there. Clearly, it is something where the input costs have impacted the profitability negatively and where on an annualized basis, profitable in new equipment, but short term in Q2, that is impacted by these headwinds.

Operator: And we'll go ahead and move on to our next question from Jeff Sprague with Vertical Research. Please go ahead.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Good morning. Good day, everyone. Thanks for the question. I'm just wondering if on China, you could unpack that a little bit further. Obviously, if your revenue is down 40% and your new equipment unit is down 10%, the implication, as you noted is, price is quite weak. But can you provide a little bit of color on how you would bridge between those two items, price versus maybe mix? Is there mix erosion going on in China also? Thank you.

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

I can take it.

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

A

Ilkka take it, yeah.

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Yeah. So, in China in the quarter, both mix as well as price contributed slightly negatively to – due to our orders. It's not a big change and pricing is more driven. Sorry, mix is more driven by somewhat lower, lower floors and as a result, slight mix and negative mix impact.

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

A

Yeah. But and you mentioned first the 40% that were – that's revenues, that's deliveries. And then 10% is orders. So two total different numbers. So that of course is just want to highlight.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Great. Thanks for that. And just as a follow-up, just on the guidance, obviously, you indicated that some of the actions might be a bit more back end loaded, the productivity and other actions. But can you give us some sense of how you see the remaining trajectory of the year playing out? How much improvement you do expect in Q3 or is this really very Q4 weighted to reach your guidance? Thank you.

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Well, I guess we are not guiding on a quarterly basis, but if you think about the nature of the actions clearly we've seen now prices, and sorry, margins for orders received starting to improve latter part of last year. Some of those start to be in delivery at the latter part of the year, so gradually contributing positively. Also, the product cost actions that we've talked about, they will gradually start to then impact also our manufacturing and be then impacting P&L. So gradually, I expect that the margins will then recover towards the latter part of the year, but we will start to see some of that slowly impacting then also Q3.

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

A

And, of course, the big difference in Q2 is that we're not expecting this type of lockdowns we had that we can have good deliveries, we have a great order book, we have a good services business. So, all of those things are in place for us.

Jeffrey Todd Sprague
Analyst, Vertical Research Partners LLC

Q

Yeah.

Operator: And we'll go ahead and move on to our next question from Andre Kukhnin with Credit Suisse. Please go ahead.

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

Q

Good afternoon and thanks so much for taking my question and follow-up. My question is on the China impact, if you could help us quantify the EBIT impact from that 40% decline? And maybe around that, the 40%, I guess, is a combination of what would be the underlying decline that already started from orders to revenue in Q1. Is there any chance to also get a gauge on how much the lockdowns added on top of that, if that's at all possible? And then I'll have follow-up.

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

A

Well, normally there's a sequential increase in revenues from Q1 to Q2 through – related to normal seasonality. And in Q2, as you said, we saw our revenue from last year decreased by 40%. So, we're talking about in order of magnitude €400 million to €500 million impact into our revenue. And then as a result, over €100 million cost or EBIT impact. There's both the drop-through, but also in this environment naturally, operating is more expensive as well. There's not one-off costs but costs related to operating in this environment.

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

Q

Right. Thank you. And is there an element of catch-up of this baked into your guidance for the full year and could you give us some idea of maybe how much of that catch up you expect maybe at the midpoint of the guidance range, please?

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

A

There is some catch up expected there. I don't think we're going to define it more in detail, but there's some – some catch up, clearly.

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Clearly, you can see, Andre, that we have a very big order book. So, at least, we have plenty to deliver, which is very positive.

Operator: And we'll go ahead and move on to our next question from Miguel Borrega with BNP Paribas, please.

Miguel Borrega
Analyst, Exane BNP Paribas

Q

Hello, everyone. Thanks for taking my questions. On the margin of orders being down year-on-year but sequentially up, can you just be a little bit more clear on what that means? Because if you were aiming for a margin of, let's say, for the sake of the argument, 5% last year when you were doing 4%, it's quite different from now that you're maybe targeting 4% for doing 1%. Is that the right way to think about this or can you give us a better picture of what sequentially better margins mean?

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

A

So, we're slightly improving sequentially, I don't think we're going to quantify that, that much more. Clearly our ambition is to be able to improve and return to the levels of margins that we've seen in the past. So those actions are ongoing and this is just a way to report the progress compared to last year and previous quarter.

Miguel Borrega
Analyst, Exane BNP Paribas

Q

Okay. And then on your order intake, how are things changing in the sense of offsetting cost inflation? Can you give us a sense of how many of these dynamic contract models have been already implemented out of Q2 orders, will this be kind of the new way of working going forward or still quite limited to certain regions and clients?

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

A

So, I would say there is – I would say Ilkka mentioned in his presentation perhaps when it comes to pricing and offsetting costs, best in the services business both maintenance and modernization; actually modernization doing very well there. New equipment business, still some way to go, but the momentum is right here, perhaps best in North America. Then both Europe and Asia Pacific, perhaps Asia Pacific has had the best momentum right now outside of China. So, many good development there.

When we think about this more dynamic contract model, so, of course, they have existed in some parts of the business, but that hasn't been a very high percentage and that, of course, then helps a bit. But it's clear that we started impact – implement that now through tenders before those are done in orders and deliveries. So, of course, it's not going to turn very quickly, but it's a longer term initiative that we think it's important to get a closer correlation between costs and order book. But I would say that momentum in getting started to implement that in the business I think actually is going pretty well.

Operator: And we'll move on to our next question from Klas Bergelind with Citi. Please go ahead.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.

Q

Thank you. Hi, Henrik, Ilkka, [ph] Klas with Citi (00:35:07). So, the first one is on your freight costs. I don't think you pass this on automatically as part of your contract. So when these costs start to go down, you alluded to Henrik that you starting to see the first signs of an improvement to supply chains, they should obviously be positive. And I also remember correctly that I think that you renegotiate the contractual part at midyear, which is right now. I'm trying to guess your timing, but also how much you buy your spot versus contract? I'll start there.

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

A

Maybe I'll start and then you can comment. And I think I'm not sure I heard you correctly you're talking about logistics, I guess, in the beginning.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.

Q

Yeah.

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

A

Ongoing contract with our logistics suppliers as with other suppliers as well. And I would say that from an input cost, logistics cost perspective, we have a pretty good visibility for the year of 2022 already. So we're committed and also start to be have a quite a clear picture on – on the mix which countries and so forth. So there overall the cost headwind now is the €200 million and there's less variability there.

In logistics, I think what has been in the past the challenge is that you have a base price, but then you need to add capacity with spot purchases on logistics. And those spot purchases have been very expensive. And I think here we're now starting to see not only the availability be there, but also then having to use less of the spot purchases and overall logistics costs, especially sea freight starts to come down. But I don't think we're going to see much of that as an impact anymore this year.

And the separate story is that then in road transportation, naturally that is then the next challenge there. The prices continue to be on a quite high level and also capacity quite tight.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.

Q

Yeah. No, I'm trying to gauge the impact with 2023. I appreciate that 2022 it's too early to see it, but anything there on contract [indiscernible] (00:37:24) if you have that Ilkka, I don't have it right now [indiscernible] (00:37:28).

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

No. I think the spot normally has not been used. During the last years, it is something where we've had to supplement then the capacity where there hasn't been enough. I think normally, I don't expect that we would start to use more of that spot purchases for logistics in larger scale.

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

A

That's why many of the trade lines have been [ph] overly full (00:37:50). You have had no flexibility if you have a little bit less at some point then you haven't. It's not really been able to move that capacity later, which is usually the possibility. So I think it's just a more stable and more – environment you can plan better right now.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.

Q

Yeah. No. That makes sense. My follow-up is on the [indiscernible] (00:38:12) we're seeing some quite big drops here. And sometimes – and you gave us an indication, Ilkka what you think the impact will be beyond this year at current spot. I don't know if you are willing to do that, but I'll give it a try.

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Sorry. Can you repeat the question? I didn't hear that it was sort of a bad line here.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.

Q

The – sorry, on the steel side, we're seeing some quite big drops and sometimes, Ilkka, you're helpful with the impact beyond this year at current spot, I don't know if you're willing to go that far, if you could hear me? Sorry.

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

A

Yes.

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Yes, now, we hear. Thanks, and sorry for that. So let's see, steel in China has come down, and whereas I would say that in outside of China, then continued to be in a quite a high level. So let's see when we get a bit closer to 2023. If the development would be similar to what we've seen now, that would start, meaning that there could be some positive, but it's too early to comment that yet.

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

A

I think the only thing we can say – the only thing we know is that volatility is likely to be high going forward which direction that we will then see.

Operator: And we'll go ahead and take our next question from Alexander Virgo with Bank of America. Please go ahead.

Alexander Virgo
Analyst, Bank of America

Q

Hi. Thanks very much. Good afternoon, gentlemen. Thanks for taking my questions. So, the first question I wanted to just touch on was the dynamics that you saw in Q1 with respect to your decisions around to whom you were delivering in China and the liquidity concerns, the quality of the customer base. I guess it's pretty difficult to disaggregate that in Q2 because of the lockdowns, but it doesn't – I don't get the impression that that has improved an awful lot. So, I'm just trying to get a sense of why you feel there can be a reasonable amount of recovery in the second half? So, that's the first question, just a little bit of a conversation around the quality of that customer base.

And the follow-up would be related to that. I guess you've seen quite a big build in working capital, partly as a function of the decisions you're making yourself and also the fact that the – the problems of lockdown. I'm just wondering how we would – you would expect to see that working capital unwind through the back half of the year so we can get a sense of cash generation? Thank you.

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Well, if I start first on the quality of customer, so I would say that in Q2 clearly, the biggest challenge was the capability to deliver. And, yes, we continue to be managing our payment terms and customer risk quite tightly, as we talked about in conjunction of Q1 results. But clearly in Q2, that impact was larger due to the lockdown measures. And going forward naturally, we will continue managing that risk quite tightly.

Then from a cash flow perspective, I think it's good to remember that when we talk about working capital change, so last year, Q2, we had a very, very good improvement in working capital. Now, it is the opposite direction about the same change, around €85 million. And out of that €85 million, roughly €50 million actually was related to the decisions we made on our business in Russia, where we are unwinding the business. So, I would not over emphasize the working capital change because at the end of the day on – if you look at the big picture, it hasn't changed much.

And naturally, when we grow, it helps us when it comes to advances, especially in the equipment business and vice versa. If we see a decrease in orders, then that would have opposite impact.

Operator: And we'll go ahead and move on to our next question from Andrew Wilson with JPMorgan. Please go ahead.

Andrew Wilson
Analyst, JPMorgan Securities Plc

Q

Hi, good afternoon. Thanks for taking my question. I think it's a bit of a follow-on from Alex's question previously, actually. I'm just trying to get a sense of, I think, [ph] when we've (00:42:31) talked before about the expectations on the second half in China, it's been, and we expected, I guess, the market conditions to improve. And obviously, I guess I'm interested in an update in how you're thinking about that. Now, clearly, it's going to improve on Q2, which is very heavily impacted by lockdowns.

But when you think about what the government has or hasn't done with regards to policy and how that's, I guess, impacting activity on the ground, can you just give us a sense of sort of if what you've seen from a policy perspective, and I guess from the customer indications perspective, that you're as confident around that recovery as you were previously? [indiscernible] (00:43:10) general question, but just really trying to get a sense on your confidence around that by improving at least the order number, I think probably for China.

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

A

I would put it that – this way that we are not expecting any massive changes in the environment and government actions. We expect that the market will continue to be as it is right, which is challenged, but they still have a big order book to deliver the developers and they will – they need to deliver that and that liquidity will continue to be quite tight.

So we're not counting on anything very significant that would happen in the market. If something significant would happen to the positive side, it would then more probably impact orders rather than deliveries. But at the same time, we're also not expecting any significant lockdowns that we saw in Q2 that, of course, there are smaller lockdowns here or there. But I think they are – they are quite manageable.

Andrew Wilson
Analyst, JPMorgan Securities Plc

Q

Thank you. And just as a follow up and I appreciate it's a slightly different area, but maybe just looking for a little bit of help on – on some of the margin drivers. Kind of talked a couple of times around the lower end product costs and some of the actions around productivity. I don't know if you could help us try and quantify some of the potential benefits. I appreciate it's often difficult to isolate these, but just to give us a bit more confidence in terms of – of the help on the margins for the second half versus and, I guess, into 2023 as well, please.

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

A

I guess on the product cost side, normally when we look at product cost actions that we take; we've seen maybe 2%, 3% decrease on an annual basis on product cost. As I said, now we've been able to see 2 times to 3 times that. Maybe that's the one way to think about the magnitude of those actions. I think the actions that we have now in place and expect to be in place for the second half are quite clearly we have a good line of sight to those actions.

And then normally it always takes a bit of time to then implement that to the new production and then start to see those [indiscernible] (00:45:20) with a lower product cost and being delivered then – and then are recognized in the P&L. So that's more the timing difference then towards the latter part of the year.

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

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

Q

Thank you. [ph] Hi, guys (00:45:36), Guillermo Peigneux-Lojo from UBS. Maybe, a follow-up question from previous questions on steel prices, especially when you look at steel prices in China. We've seen spot basically going down in some instances by a third and rather than ask in the magnitudes. Can we ask when would you start to see it in your P&L i.e. basically when would you start to filter through these lower cost levels in your Chinese installations, if I may? And I have a follow-up.

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

A

Well, if the prices were, as you said, then we would start to see the benefit in first half of next year. There's always a timing difference as you saw in 2021 when the prices were going up. We were mostly not impacted in the first half, start to really then impact in third quarter and the fourth quarter. So there's a three months to six months lag normally. This year, we already have quite a good visibility, where quite prices are locked with our suppliers and also with the inventory rotation. So I would not expect big changes anymore in to this year's results, but sometime then early next year.

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

Q

Thank you. And my follow-up is, I worry a bit about pricing now that obviously, the China recovery will be there [indiscernible] (00:47:09-00:47:17) and with raw mats going down, what do you think pricing will do next year? I know it's a bit early to ask, but would you say that there is a chance that actually we will assume pricing pressures to the magnitude that people would likely gain market share in a flat market or in a potentially weak market? Thank you.

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

A

I think we need to put it in perspective as well that there's still a way to do to catch up with prices have gone up. And I think that everyone in the industry are feeling it so clearly. And then when you look at China, where costs are then coming more down, you have not seen price increases there. So from that perspective, I would not be so worried about that.

I trust that everyone understands that, hey, there is a need to improve margins throughout the industry, and therefore, driving a better margin. And that's what we are very focused on right now. We have also have to see, but – and it's also a big difference if you look at Europe here actually steel price there continue to be at the very high level. US perhaps slightly down, but also at the high level. And I guess it has – in Europe it has a lot to do with the energy crisis that we are facing here right now.

Operator: We'll go ahead and move on to our next question from Martin Flueckiger with Kepler. Please go ahead.

Martin Flueckiger
Analyst, Kepler Cheuvreux SA (Switzerland)

Q

Yeah. Afternoon, gentlemen. Thanks for taking my question. Again on China, I'm afraid. We've been reading about these revolts by apartment or housing buyers in China. And quite literally, the images and the videos that we were able to see were a bit frightening too about what's going to happen here. And I've seen what the regulators are suggesting to the banks, but I was just wondering what the kind of feedback was that you've got, that you received from your team in China. How they view situation and what they make out of this going forward, whether the downward spiral will be broken or whether there is further downside risk from here. And I have a follow-up after that.

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

A

Okay. So, clearly, that has been a lot in the press over the past days. Yeah. Of course, if consumers have made a downpayment, are paying mortgage already and not getting the delivery of their apartment, clearly that's a concern and we are seeing that the government is taking action to make sure that the developers are speeding up so that they can deliver this.

And that should have – should have a somewhat positive impact for us if deliveries are actually speeded up because of this so we can complete installations and hopefully slightly better liquidity for them. But clearly, this is a topic they need to take seriously, but I think they are taking seriously. So we have to see how it develops. But as I've said, it seems that the government is stepping in here quite clearly to protect the consumers.

Martin Flueckiger
Analyst, Kepler Cheuvreux SA (Switzerland)

Q

Okay. Then my follow-up is just a clarification question really to Ilkka. Did I understand you correctly that the China impact on adjusted EBIT in Q2 was €100 million, you mentioned two numbers that I wasn't sure which one was which.

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Yes. I said over €100 million in Q2 results.

Operator: And we'll go ahead and move on to our next question from – comes from [indiscernible] (00:50:58).

Q

Yes. Hi, Henrik and Ilkka. I have two questions. First, I wonder about the margin on orders received. Now, if you compare that to Q3 last year, are we still down year-on-year? I mean, that was when you had the big drop or are we now on par with the level in Q3 last year?

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

A

We are up from last year's Q3. So up in Q4, Q1 and now in Q2 as well. So that is up.

Q

Okay. And then you have always said that this industry doesn't really have any peak capacity [indiscernible] (00:51:46) a lot of costs, and still we have seen this kind of big margin collapse throughout the industry almost it seems. And it's kind of hard to believe that companies would not really know what's going on because of some pricing. I mean, many other industries are doing very well.

So, from a like more philosophical kind of point of view, what do you think is kind of the really the problem? Is it only the China exposure, but it seems to have progressed in modern equipment, also in other Western markets in a different fashion than we see in other industries? Now, that's kind of – that's kind of hard to understand why it would be more difficult in this industry than in any other engineering industries at the moment.

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

A

So, I would it in two different buckets. If you look at the services business, actually there prices are up so to cover costs, and in some cases even more than that. Of course, it takes a bit of time for modernization to come through the order book, but it's much faster moving. In new equipment, it's a business that is very much driven by tenders, very competitive there. And then, of course, the challenge is that you have a long order book. So, before – you have tender prices up before orders are there. It takes a good time for it to come through. But clearly there, price development has been slower than, for example, in the services business. And it's just that the commercial dynamics are different, but it's kind of two very different stories. If you look at services and new equipment.

I would say new equipment, we are clearly up in prices outside of China so far this year. So we're definitely going in the right direction. And I think in most markets we'll get there. I'm very confident with that. It just takes a little bit of time.

Operator: And our next question comes from Daniela Costa with Goldman Sachs. Please go ahead.

Daniela Costa
Analyst, Goldman Sachs International Q

Thank you for taking my follow up. I just wanted to ask back on – on China, obviously, on the backlog, which I guess is a sizable portion of your overall backlog. But we are seeing a lot of uncertainty, I guess, around what happens in the local market. Can you recall just like how long do you keep things in the backlog until you have to maybe write them off? I think you did this in the prior crisis once I know we're not there yet, but just to have an idea on how should we think about the length of the backlog and delivery. Thank you.

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

Well, I guess overall, our fastest circulating order book in the new equipment business is in China. Approximately nine months in terms of circulation. And so – so that's the overall picture. Then we assess the quality of the order book continuously every quarter. And as a result, then cancel orders in case they are not likely to be delivered.

Amount of cancellations have remained to be low. And I think in this quarter particularly, we actually canceled on ourselves the Russia-related orders, which took that up a bit. But in China, it has continued to be on a low level. And to be honest, if we look at the past, still the cancellations, I mean, there were some in the 2016, 2017 when the prices came down quite dramatically. But otherwise, it's been more stable and the cancellations from customers have been actually quite a low level.

Daniela Costa
Analyst, Goldman Sachs International Q

And the rotation at the moment is still within those nine months. It hasn't extended from order to delivery?

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

The order circulation has, then as a result, I mean, we didn't deliver as many orders as we expected. So, it is slightly up as a result, but I would say that still the nine months is a good way to think about it.

Daniela Costa
Analyst, Goldman Sachs International Q

Okay. Thank you very much.

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

Thank you.

Operator: And we'll go ahead and take our last question from Andre Kukhnin with Credit Suisse. Please go ahead.

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

Q

Hi, again. Thanks so much for taking the follow-up question. I wanted to come back first to those mitigating measures and just to get the confirmation of sizes. I think at your Capital Markets Day, you said that together, pricing and cost-out measures should mitigate about half of the cumulative raw materials and logistics headwind, which are adding up to €400 million now across 2021 and 2022. So, is it right to think that you've got that kind of €200 million annualized tailwind coming in, and gradually from Q3 this year into Q4, and then building up to the full run rate by end of first half of 2023? Would that be the right cadence and right magnitude?

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Well, I guess what we said there was it was a status check where we are. And now, with actions continuing to progress positively, we're a bit better than that. But – and the comment was especially about the new equipment business – new equipment business.

Then in the maintenance and modernization, as we said, we are actually progressing much faster than that, and almost there when it comes to countering the cost headwind, when it comes to the modernization business. And that's naturally then a bit faster circulating. On the new equipment side, it will take some time for those orders that we continuously book now where they improve in margins then to come to delivery. And in China, as I said, the order book rotation is around nine months. And then if you look at Europe being over a year and North America, then clearly over a year. So, clearly that's then how it will be visible in the P&L when it comes to the pricing part.

On the product cost side, we'll gradually start to see more and more of that coming through in the latter part of this year and probably during the first half then in full extent. But as always, we're not stopping to improve our product cost. So, hopefully see then continuous good progress there on next year as well.

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

A

And I think, Andre, I think your math sounds clear, but it's perhaps not quite that straightforward because the €200 million this year, that includes already some of the benefits from the improvement actions. So yes, of course, our target is to come back to the levels we were a while ago. We still have some way to go there, but it's not quite that, you can say €200 million immediately improvement in a short term because some of that improvement is already baked into that €200 million. But of course, lot of actions continue, and I must say I'm quite positive how our pricing outside of China is developing right now. Momentum is definitely there.

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

Q

Got it. Okay. So, €200 million this year would have been high if you haven't taken some of these measures [indiscernible] (00:59:09).

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Indeed.

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

Q

...right. And on the ambition – thank you. And on the ambition of getting that order intake or order backlog margin up to where it was historically at the 2020 level. How far below are we at the moment? Is there any way to tell?

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Well, I think first, what we've commented is the orders that we book those margins then and in order book, there's always a mix impacts when it comes to businesses and geographies. So it's not as a good proxy of the future. But clearly, our ambition that we've commented was on the orders booked.

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

A

Yeah. And I think if you book orders, for example, last quarter, this year, not necessarily – it's not going to necessarily show up in the following year, some will, but not all. So it's going to be a gradual improvement. I think the important thing is that pricing is definitely taking us in the right direction. And from services, we're seeing faster impact then from new equipment.

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

Q

Right. And sorry, very quick last one I know we're an hour. The – just looking at Q2 performance and what you said about China being down 40%, that still implies down a couple of percent for kind of the rest to get to the 15...

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

A

Yes,

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

Q

...15.2% overall. And in the rest, we've got services up. So I just wanted to check if the new equipment, there was softness elsewhere in the second quarter that we should be aware of and then find out whether that run rate or any one-off effects?

Ilkka Hara
Chief Financial Officer & Member-Executive Board, Kone Oyj

A

Well, I guess, sales in Europe, Middle East, Africa were down in the quarter. And there we are seeing that some of the customers, especially in the new equipment side, are having difficulties in taking their projects forward as they planned. It's about having the supply chain access to labor and so on that are impacting the projects. So, slight delays from that respect, impacting the revenue in the quarter. North America as well, some impact of especially labor, I guess. They're being tight. But as I said, we saw growth in the sales in US, so slightly less while the mix is less new equipment heavy, so less impact from there. So, in essence, so we do see some slowness in the construction side.

Operator: And with that, that does conclude our question-and-answer session for today. I would now like to hand the call back over to Natalia for any additional or closing remarks.

Natalia Valtasaari

Head-Investor Relations, Kone Oyj

Thank you and thank you, Henrik and Ilkka, for the presentation today. Thanks to everyone online for joining in and for the active questions. If you do have any follow-ups, please do feel free to reach out to me and the team. If not, I would like to wish you all a very happy summer.

Henrik Georg Fredrik Ehrnrooth

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

Thank you, everyone.