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Q3 2018 Draegerwerk AG & Co KGaA Earnings Call

EVENT DATE/TIME: OCTOBER 30, 2018 / 2:00PM GMT

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PRESENTATION

Operator

Good afternoon, and welcome to the conference call of Dragerwerk AG & Co. KGaA, which is now starting. At our customer's request, the conference will be recorded. You can listen to the recorded conference for the next 7 days by dialing +49-30-868-757-330 for German or +49-30-868-757-360 for English menu navigation. The pin code for the replay service is 697209 followed by the hash key.

The management presentation for the following conference is available on Dräger homepage, www.draeger.com. Press investor, and there you will find the presentation under Financial Calendar.

May I hand you over to Mr. Stefan Dräger, CEO of Drägerwerk AG & Co. KGaA, and the moderator of this conference.

Stefan A. Dräger ***Drägerwerk AG & Co. KGaA - Chairman of Executive Board & CEO - Drägerwerk Verwaltungs AG***

Good afternoon, and a warm welcome to everyone joining us today on the phone or via the webcast online. I have with me today Gert-Hartwig Lescow, CFO; Melanie Kamann, the corporate spokeswoman; Tom Fischler, Investor Relations; and Peter Müller, Financial Communication. We would like to guide you through the presentation covering our results for the first 9 months, which we made available on our homepage this morning.

I will start with the high-level overview over the business development and the demand trends we have seen in the regions, before Gert-Hartwig will go into the financial details of the quarter and 9-month period. Following the presentation, we'll be -- the floor open for your questions. Out of respect to everybody's time, we will end this conference in 1 hour.

Already 2 weeks ago, we published preliminary figures for the third quarter. In the final set of figures published today, there are no meaningful deviations to the figures you already know.

Let's get started on Page #3 with the business highlights for the first 9 months. I'll start with a short revenue of the quarterly developments so far. We had a very slow start into the year. Despite the currency-adjusted order growth in Q1 of roughly 2.5%, net sales development was sluggish. Next to other things, a big factor of this weak net sales volume at the beginning of the year was the weak delivery performance in our consumer goods business due to the ramp-up of our logistics hub in Frankfurt. The weak top line, together with the higher expenses, resulted in a negative Q1 EBIT of roughly minus EUR 40 million.

During the second quarter, our business development had improved. Currency-adjusted order intake growth continued to be positive, and there was a strong catch-up of net sales. With a currency-adjusted year-over-year net sales increase of 10%, the second quarter delivered very solid growth. To be fair, this was, in part, a spillover effect from the lower delivery volume in the first quarter. A portion of orders that weren't closed in Q1 were then delivered and built in Q2. So after 6 months, net sales were nominally pretty much on the level of the prior year, corresponding to a solid growth of 4%, if you take out the negative currency effects. And even if Q2 EBIT had improved versus the very weak first quarter, the Q2 EBIT was nevertheless on a low level. For the 6-months period, EBIT was negative. At that time, it was obvious that it would require a strong second half of the year in order to reach the EBIT guidance for the full year. But if you take into account the positive order development at that time, reaching the guidance was still very much possible.

In the third quarter, we continued to see good order growth. In fact, with order entry increasing by some 7.5% versus the prior year, Q3, order growth was very solid. The order development throughout the year demonstrates that our market remain intact and continue to grow. Nevertheless, net sales development in Q3 was not quite as good as the order intake development. Currency-adjusted net sales growth was some 6 percentage points lower than order entry growth. Our net sales volume in nominal terms has declined in Q3. Another important factor of the disappointing Q3 earnings is the unfavorable currency development. Unfortunately, the negative impact from foreign exchange has substantially increased during the last quarter, especially from the strong devaluation of some emerging market currencies. At that time functional expenses have increased in line with our investment program into R&D and into some specific skills in sales and services. As a result, Q3 EBIT is negative and clearly below our expectations. For the 9-month period, EBIT is minus EUR 41 million, which is insufficient to be able to reach our full year EBIT guidance. More on the guidance soon when we get to the outlook, towards the end of our presentation.

First, let's take a look at some of the top line trends within our regions, Page 4. Starting with the group figures on the lower side of the chart. For the 9-months period, order intake amounts to roughly EUR 1.93 billion, corresponding to a year-over-year currency-adjusted improvement of 3.8%. Net sales are lagging somewhat behind this development, with a currency-adjusted growth of 3%. As I said, due to the foreign exchange headwinds, the nominal development is much less favorable. For the first 9 months, the nominal net sales volume shows a slight decline of 0.5%.

In particular, the demand for our safety offerings is above the level in the prior year. Double-digit growth in Q3 lifted the order increase for the 9-months period to plus 5.7%. This growth was supported from all 3 regions and nearly all safety product areas. Particularly good development in our gas detection business and also orders in engineered solutions were significantly up over -- year-over-year.

So far, order intake for our medical business was not quite as strong, but nevertheless, also, medical continues on its growth trajectory. Plus 6% in Q3 brings order intake for the 9-month period to close to 3%. Within the medical product area, order intake for anesthesia was strong as well as for thermal regulation. On the software side was the order development for workplace infrastructure as well as for ventilation. Also, in medical, all 3 regions contributed to growth, with the highest growth coming from the AAA region.

Now some comments on the development within the regions, starting with the region America, on the top of the chart. After 6 months, the region Americas had not yet been able to grow the business. In Q3, the business improved a lot. We had double-digit order growth in the region. For the 9-month period, orders are now up by 4%, but unfortunately, there are quite pronounced FX headwinds coming from the region, from some currencies in South America, to be specific. As a consequence, nominally, order volume is still roughly 4% below the prior year's level. In the region, especially orders for our medical products, recovered during Q3, bringing the medical business back on a growth trajectory. Growth was particularly strong in South America with double-digit growth for safety as well as medical offerings. But also, North America had a strong third quarter, bringing the 9-months development back on a stable level again.

Moving on to Europe, where order intake increased in the first 9 months by some 1.5%. Both product areas contributed, but stronger growth came from safety. Within Europe, especially Germany, our largest single country in terms of net sales, has contributed to order growth. Despite a somewhat weaker Q3 development, orders have increased in Germany by some 5% year-to-date. There was a strong development in the Nordics countries as well, where we won some larger anesthesia deals, for example. On the flip side, some other important large countries, like France or Russia, so far have not contributed to order growth.

Last but not least, our AAA regions, that is Africa, Asia and Australia, they also had a strong third quarter, with double-digit order growth. After 9 months, with a constant currency order growth of some 8.5%, AAA is the region with the highest year-to-date order growth. As it is the case with the Americas regions, also, in the AAA, the negative currency effects are quite pronounced. We are losing some 4 percentage points in order growth and net sales growth due to FX.

Trends on a country level has little changed from what we have been seeing also after Q2. Hence, a demand in development from China, Japan and Australia, for example; and some less favorable development in other countries like in the Middle East. Both medical and safety are going with a high single-digit, low double-digit rate.

With that, I turn over to Gert-Hartwig for a revenue of the financials, and I'd like to come back with the summary and the outlook.

Gert-Hartwig, please.

Gert-Hartwig Lescow ***Drägerwerk AG & Co. KGaA - Vice Chairman of Executive Board & CFO - Drägerwerk Verwaltungs AG***

Thank you, Stefan. I would like to welcome everybody to our conference call on the results of the first 9 months. Before I start with the financial development of the group, I would like to clarify that whenever referring to growth rates, I will be stating values in constant currencies unless stated otherwise.

Please turn to Page 5 for a review of the Dräger P&L. For the third quarter, as Stefan Dräger explained, order entry in Q3 was strong with 7.6% growth over the same quarter last year. The only 1.3% growth, net sales in the quarter, we're lagging behind the good order entry development. On a nominal basis, our sales volume is down by more than 1% year-over-year. For the top line, there are mainly 2 factors to consider in my opinion: first, the time lag of orders turning into sales; and second, the low nominal volume due to the currency effects. Next to the lower volume, there were some substantial negative valuation impacts from currencies impacting quarterly earnings, especially, the revaluation of receivables from emerging markets. In particular, those denominated in Turkish lira or the Argentinian peso have led to negative valuation effects of the Q3 P&L.

The was gross profit margin of Q2 -- Q3 was 42.2%. It declined by about a percentage point from the Q2 margin and even nearly 3 percentage points from the prior year's quarterly margin. Negative currency effects were the biggest factor for the lower margin in the quarter, but next to other things, higher quality costs and the cost of goods sold also burdened the margin. In total, low volume, lower gross margin and higher expenses, our quarterly EBIT is negative at minus EUR 4.4 million.

After 9 months, year-to-date, this adds up to unsatisfactory result. Despite currency-adjusted growth of 3%, the nominal net sales volume is below the prior year's level. The year-to-date gross margin is some 2 percentage points below the level 1 year ago. The aforementioned FX effects are the biggest single effect and are responsible for about 1/3 of the decline. The remainder is, among other things, due to lower product margin and adverse mix effects.

The margin declined in all 3 regions. While the gross profit contribution declined in AAA and America, it was stable in Europe due to the higher net sales volume. Despite the expected strong Q4, we will probably stay below the originally expected gross profit margin for the full year.

Year-to-date EBIT is negative with minus EUR 41 million, which is insufficient to be able to reach the previous EBIT margin guidance range of 4% to 6% for the full year. In total, FX had an impact of 2 percentage points on the year-to-date EBIT margin. Based on spot rates, we do not expect any material improvement in the current quarter. For the full year, the impact on the EBIT margin will remain on this level of roughly 2 percentage points. Compared to our expectation at the beginning of the year, this is substantial headwind on EBIT, which we will not be able to compensate.

Turning to the expense development, on Page 6. We are pursuing our investment plan with additional spending in research and development and sales and service during 2018 and '19. Since this is mainly an investment into development, engineers, in sales and service staff, our headcount has increased in the course of the year.

In line with the investment plan, functional expenses increased by some 8% for the first 9 months. Currency effect provided some relief for functional costs. As a result, the increase in nominal terms amounted to 5.6%. Factors behind this rise included the planned increase and expenses for product development and sales, higher freight cost as well as wage and salary increases.

Expenditure on research and development increased at the highest rate of 13.2%. An important focus of the investment plan is to drive our product growth map forward. Net of relief effects related to currency, selling and marketing costs were up 7.4% year-on-year. The expense increase also include some unplanned costs due to the issues at our logistics hub in Frankfurt. In order to secure the delivery performance during the high-volume year and business, we took the decision to relocate some of the volume back to Lubeck. Also, cost of freight is higher than planned due to tariff increases as well as a higher portion of air freight in order to improve delivery times. The expense increase was most marked in the Americas as well as in the Africa, Asia and Australia segment and was largely due to higher logistic costs.

In reaction to the weak profitability at the start of the year, we have decided to reduce expense budgets of the region as well as the central functions in the magnitude of approximately EUR 25 million. As a consequence, the increase was lower in the third quarter than in the first half of the year. Nevertheless, functional expenses are increasing at a higher rate than net sales and are burdening profitability.

Let's move on to some key ratios on Page 7. Cash generation in Q3 was positive and has improved compared to the level after 6 months. Nevertheless, the level after 9 months remains negative and is clearly below the prior year level. In the first 9 months of the year, Dräger had a cash outflow from operating activities of some EUR 42 million compared to cash inflow of EUR 78.5 million in the prior year period.

The reasons for this unfavorable development is primarily the lower year-to-date profitability in 2018, but also, inventories increased by a greater margin than in the prior-year period. Of a lower magnitude, but nevertheless negative for operating cash flow, was an unfavorable development of the receivables and payables, which could only partially be compensated for by the lower increase of the other assets. We expect operating cash flow to continue to improve in Q4, but cash generation in 2018 will not reach the prior year's levels.

Since cash outflow from investment is only a little lower than 2017, free cash flow also is clearly below the level of last year. The lower cash flow also resulted in higher net financial debt, but with a net-debt-to EBITDA at roughly 0.4, leverage of the group remains conservative.

All -- another result of the lower 2018 earnings is that the year-to-date DVA development is below our expectations. With the 12-months rolling EBIT being significantly lower than 1 year ago and cost of capital slightly up, the Dräger value added has substantially declined. The DVA stands at minus EUR 16.1 million. For the full year, the DVA will probably remain in negative territory.

And one last point, net working capital has increased in the course of the year. This is not a question of the DSOs. In fact, DSOs have improved by a day. The increase in net working capital is due to higher inventory levels. The high inventory level are, in part, preproduction of equipment to be delivered during the year-end business. The 12-months average of the days of working capital has increased by 1 day to roughly 115 days.

With this, I would like to hand it back over to you, Stefan.

Stefan A. Dräger ***Drägerwerk AG & Co. KGaA - Chairman of Executive Board & CEO - Drägerwerk Verwaltungs AG***

Well, thank you, Gert-Hartwig. Ladies and gentlemen, let me summarize today's presentation on Dräger's results for the first 9 months of 2018. In the past quarters, currency-adjusted order entry growth remains positive. Especially, the strong order entry development in Q3 indicates that the poor earnings development is not a question of deteriorating market conditions or a lack of focus on our customers. The reasons have to do with the nominal net sales volume due to negative effects from the devaluating emerging market currencies and the higher cost base due to planned cost increases from our investment program as well as some unplanned incurred costs like the logistics cost we talked about.

Currency-adjusted net sales development, so far, is characterized by high quarterly volatility. The slow start into the year was in part homemade, but with a strong catch-up in the second quarter in particular, our currency-adjusted net sales growth is, so far, a plus of 3% better than our top line guidance range for the full year.

Taking the negative currencies effects into account, then the nominal top line development paints a less favorable picture. On a nominal basis, our net sales volume is still lower than 1 year ago. This naturally has a negative impact on our earnings. In fact, as discussed, FX is a big reason for the disappointing earnings development.

At the beginning of the year, we had anticipated to have negative effects from FX of about 1 percentage point on the EBIT margin. And with the additional strong headwinds we see today, we expect the expected impact is more to be in the 2 percentage points area of the EBIT margin. A second big factor are some higher-than-planned costs in logistics and for our quality measures currently implemented. These higher-than-planned costs will amount to roughly EUR 25 million for the full year. So compared with our expectations at the beginning of the year, we are losing roughly 2 percentage points EBIT margin due to the stronger FX headwinds and unplanned higher costs for logistics and quality. We won't be able to compensate these negative effects. We, therefore, have reduced our expectation for the full year EBIT margin to a range of 2% to 3.5%.

Q4 remains key. The comparable basis, Q4 2017, is high. But based on the good order entry we had in the past quarter, and also, the volume that we see in our sales funnel, we expect to see an even stronger Q4 this year. Despite the existing FX headwinds, which will probably remain with us also in Q4, the expected sales volume should be sufficient to beat the strong last year's Q4 top and bottom line.

With the announcement of the lower EBIT guidance 2 weeks ago, we also said that it is unlikely that we will see a substantial improvement in profitability in 2019. Next to an unfavorable FX environment that would result in nominal net sales volumes from some emerging markets remaining low, some of the higher costs that burdened 2018 will also remain in 2019.

Our investment program is beneficial for the long-term development of the company. The money is spent to strengthen our product portfolio and specific sales skills. We will therefore continue with the program, otherwise, we would see delays in product launches that would lead to prolonging the period before we can return to higher profitability again. We will specify this in more detail when we know the full year results.

With this, I would like to end the presentation and hand over to the operator to open the line for your questions, please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question comes from Mr. Falko Friedrichs from Deutsche Bank.

Falko Friedrichs ***Deutsche Bank AG, Research Division - Research Analyst***

A couple from my end. Firstly, on the unplanned logistic costs, can you tell us if the situation is improving here and how many additional costs we can expect in 2019? Secondly, on the quality-related costs, it would be great if you can provide a bit more color on these and whether there is anything that we should be worried about going into 2019 on the product side. Then a quick one on the FX tracks, maybe you could share a first indication of what we might expect in 2019 here for both sales and EBIT margins. And then lastly, on the outlook for the European business in 2019, maybe you could provide some color here and your expectations, given that orders have been rather low this year.

Stefan A. Dräger ***Drägerwerk AG & Co. KGaA - Chairman of Executive Board & CEO - Drägerwerk Verwaltungs AG***

Well, it's Stefan Dräger speaking. I'll start with your first question, Mr. Friedrichs. The -- on the logistic cost, there is significant improvement on the logistics itself. So the issues we experienced in the -- it did have an effect, not only, say, on the financial side. As you could see, that the sales were slightly lower in Q1 and then recovered in Q2. Behind every such [unit] that was delayed is, of course, a lot -- often dissatisfied customer, and say, a lot of people within the organization are trying to fix it and to satisfy the customer. And all this has improved, so we sorted this out in a great effort to be ready for the Q4. That is our ultimate goal, to be able to deliver a super Q4, say, surpassing the good one that we already had last year in 2017. So the situation has improved and it stabilized. However, the cost that we spent will not completely go away. The running cost that we carry on in -- and over into the next year is a, I will say, high single million euro amount that we transfer into the next year. And during the course of next year, we, of course, continue to work on further steps. So that is an order of magnitude for you. So the issues have been resolved. The customer is again fully satisfied. We are Q4 ready. However, some single million euro cost transfer into the next year as well. And some, we have this year, but that amount is already -- next year, again, next year. The second point, quality cost, should you be worried about the quality measures? This is, of course, a sensitive issue. If we hear the word quality, other, say, industries have also quality issues, if I think of the quality issues in automotive industry. Ours are different nature. Since -- so almost none of the things we have been worried ourselves have reached our customer. So we spent some extra effort and costs to secure and make sure that a customer get the quality that they rightfully expect from Dräger. And I expect that this will not repeat in the next year. So your third question?

Gert-Hartwig Lescow ***Drägerwerk AG & Co. KGaA - Vice Chairman of Executive Board & CFO - Drägerwerk Verwaltungs AG***

The third question was for the FX for 2019. I'm not sure how the question is meant. Obviously, we don't have a crystal ball to see what the currencies will look like in 2019. But what we can say is that, in fact, the currency have deteriorated somewhat in the third quarter. So if we project that into 2019, everything else being equal, we would expect a slight headwind for the full year of 2019 compared to 2018. I would like to add also, we had, in fact, the logistics costs from our hub in Frankfurt. And it's exactly as Stefan Dräger said, we expect some remaining costs for 2019. We also see that freight rates have increased in the course of 2019, and while we have renegotiated that, we expect that part of that will also burden 2019. So all in, if we combine the 2 factors, the cost burden compared to the status quo ante is -- can exceed EUR 10 million and can go up to EUR 15 million for 2019. And while we do not expect any quality issues from individual products, we currently see that the sum -- or we expect the sum of quality-induced costs to be on a similar level for 2019 as well for 2019 -- so but not with any concern necessarily to individual products. That's just the nature of the business that we face. And I think the last question was for the outlook in Europe?

Stefan A. Dräger ***Drägerwerk AG & Co. KGaA - Chairman of Executive Board & CEO - Drägerwerk Verwaltungs AG***

On the whole of Europe or -- yes, well, Europe in our terms includes Turkey, Russia and other countries, and of course, United Kingdom. So I would say, whilst countries like I mentioned during the presentation, Germany has a solid growth of 5%, I mean, for a mature, saturated market, I think this is quite good. If you would expect this for all of Europe, unfortunately, it's not true because it's diluted by these, say, countries that are on a decline. So overall, it should be a slight growth, but don't expect too much growth. Yes, but not much.

Operator

The next question comes from Mr. Aliaksandr Halitsa from Hauck & Aufhäuser.

Aliaksandr Halitsa ***Hauck & Aufhäuser Privatbankiers AG, Research Division - Equity Analyst***

I was wondering if you could discuss a little bit what assumptions are built into the lower end and the upper end of the guidance in terms of the -- for the FX development of the export market currencies?

Gert-Hartwig Lescow ***Drägerwerk AG & Co. KGaA - Vice Chairman of Executive Board & CFO - Drägerwerk Verwaltungs AG***

I first thought the question was about the guidance for the EBIT margin. In fact, what we expect for the currencies, that they remain roughly at the current level. We have -- if you will, we're not planning on an individual outlook. Of course, if we look at the upper and the lower end for guidance for the remainder of the year, it's -- it includes a couple of the factors that we bundle in 2 different scenarios. So the upper end is full delivery of our net sales, developed -- of our deal flow, as Stefan Dräger has described. And we do see a very solid funnel for the Q4, accompanied by a more positive realization when it comes to gross profit. And on the flip side, we factor in -- on the lower end of the guidance, we factor in still growth in the fourth quarter, but not to the full extent possible compared to our funnel, and continued pressure on the gross profit margin. And with that, we would see that the fourth quarter, while being positive on an EBIT level, will not fully compensate the decline. It's not, if you will, a detailed scenario where we would forecast in Argentinian peso as a standalone scenario, but we factor that in for different scenarios.

Aliaksandr Halitsa ***Hauck & Aufhäuser Privatbankiers AG, Research Division - Equity Analyst***

I'm just wondering, because if I look at the -- you mentioned that you expect Q4 to be even stronger than last year. And we know that currencies in Q4 have developed unfavorably. We see also that the major currencies have devalued on average by 30%, which would mean that the gross margin will come again under pressure. But still, you expect the EBIT to be even on the higher level than last year, which were already acceptable.

Gert-Hartwig Lescow ***Drägerwerk AG & Co. KGaA - Vice Chairman of Executive Board & CFO - Drägerwerk Verwaltungs AG***

The higher level -- in the high-end scenario, whereby the higher top line is the key driver, as it can be seen on the flip side in the third quarter, where we have seen very strong order entry but not materializing into sales. And we would expect that, also, that addition to the orders on hand will translate into net sales for the quarter. So the key driver is net sales growth on the fourth quarter.

Operator

At the moment, there seem to be no further questions. (Operator Instructions) There are no further questions left.

Stefan A. Dräger ***Drägerwerk AG & Co. KGaA - Chairman of Executive Board & CEO - Drägerwerk Verwaltungs AG***

Okay. If there are no further questions, then I would like to close the call. And thank you all very much, ladies and gentlemen, for your interest in our -- today's call. And for your questions, very much appreciated. Looking forward to talking and meeting you soon. Have a great day. Bye-bye.