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C: Bernard Schäferbarthold; HELLA KGaA Hueck & Co; CFO
P: Ashik Kurian; Jefferies; Analyst
P: Christian Breitsprecher; Macquarie; Analyst
P: Christian Ludwig; Bankhaus Lampe; Analyst
P: Lello Della Regione; Intermonte; Analyst
P: Viktoria Oushatova, BofA Merrill Lynch; Analyst
P: Operator

COMPANY EDITED TRANSCRIPT

Operator: This is conference # 962674.

Good afternoon, ladies and gentlemen. Thank you for standing by, and welcome to the HELLA Investor Update First Quarter Financial Year 2017-2018 Webcast.

(Operator Instructions) I must also advise you that this conference is being recorded today, Wednesday, the 27th of September 2017.

And now I'm handing the conference over to your presenters today, Dr. Rolf Breidenbach, CEO and President; and Mr. Bernard Schäferbarthold, CFO. Please go ahead.

Rolf Breidenbach^

Yes, thanks very much. This is Rolf Breidenbach speaking. Also, good afternoon from my side and also on behalf of Mr. Schäferbarthold. I really appreciate that you are taking the time for this telephone conference to discuss with us our first quarter results of the new fiscal year 2017-2018.

We, from our perspective, started well into our fiscal year. With regard to sales, we could show a sales growth by 5.8%. This means we are now, for the first quarter, at a level of EUR 1.6 billion. So I would say we are back on track with regards to the outperformance of the automotive markets, and I will come to that topic back a little bit later.

With regards to profitability, our adjusted gross profit margin for the first quarter is at a level of 27.7%. So 0.2%-points better on a year-on-year basis.

Our EBIT, also adjusted, increased by EUR 7 million, now to EUR 125 million. And our adjusted EBIT margin also improved by 0.1%-points to 7.7%, which, from our perspective, is a good financial performance.

So when you go into the details, we can see that the gross profit in the Automotive segment reduced by 0.4%-points to EUR 24.6 million. This has to do with a little bit reduced utilization of our worldwide plant network. We have to remember that we are building up a lot of new plants, 4 new electronic plants, and we also increased our capacity in lighting, for example, in Mexico. And therefore, we are currently not able to run the whole production footprint. It's a very, very high utilization we could show last year. On the other hand, the 2 other segments could compensate this and, therefore, the gross profit overall could be improved.

When we look at the adjusted EBIT margin, here, again, we suffered a little bit from the weakness with regard to our Chinese and South Korean joint ventures. On the other hand, we are very satisfied with the performance of our Special Applications segment. And therefore, overall, we were able to also improve at the EBIT level.

When we look at the free cash flow, here we could show a significant increase by EUR 30 million. This has to do, on the one hand, with an increase of funds from operations and also a lower working capital consumption. So an operational improvement, which, in our opinion, shows that we are, let's say, on a good track to improve also our cash conversion rates, which is a special topic my colleague, Mr. Schäferbarthold, has a special eye on. And yes, we are quite satisfied with the improvement of this program so far.

When we look at the adjustment at the sales level, you can see that we suffered a little bit with regard to the currency development, and the Euro currency is very strong compared especially to the U.S. dollar. And therefore, we had this 5.8% growth rate at adjusted level and this 4.9% in considering these currency effects.

Automotive was a, let's say, growth engine in the first quarter, we could show of growth rate of 5.9% but also the development in the Aftermarket with 2.0% is, when we look at the overall development of the markets, more than satisfying. Of course, we got a special boost in Special Applications. Both the agriculture as well as the construction market is back, both markets show a very solid and strong double-digit growth rate. And therefore, we could significantly increase the sales in the Special Applications segment. And we do not see that this good market development in both in the construction market and also agricultural market will stop in the months to come. So in our perspective, it's quite positive here.

As I already said, and this is shown in the third slide, we are back with regard of our outperformance of the global automotive markets. When we look at a global basis, our outperformance was at a level of 4.5%. So we see that the global market has grown by around 1% compared to our, let's say, 5.8% I already mentioned. The outperformance in Europe is okay with 0.6%. But of course, we are very satisfied with the development in North and South America, an outperformance level of around 19.5%, and also the development in Asia. Here also, a special focus in China is significant from our perspective with 8%.

So overall, I think we are back on track with regard to our growth perspective. We discussed in the last quarters that the last fiscal year was a special year due to a lot of launches and end of production of other products. Now we see that the sales in all segments is coming back to, from our perspective, a very satisfying level, and we also think that this will be true in the months to come.

Okay, this was the overall overview with regard to our first quarter. And now I would like to hand over to our CFO, Mr. Schäferbarthold, who will give you more insights of our financial results.

Bernard Schäferbarthold^

Thank you, Mr. Breidenbach. Good afternoon also from my side. I would like to continue on Page 8 with more details.

Before starting, I would basically give you my 3 main topics first. First also, Dr. Breidenbach stated, and I can only, I would say, state it also that we were, in the first quarter, absolutely in line with our expectations in regards to sales and EBIT.

Second is if you look where the growth was, we were not really supported by the FX development in U.S. dollar and Renminbi. Both currencies are weaker in comparison also to last year so that if we do our calculations, especially related to translation effects, we are losing in absolute terms around 2% on EBIT. And that's also if we look at our predictions for the year, that's around that number, what we also see on the full year.

Third is if we look at free cash flow, Dr. Breidenbach also said that it was a very, I would say, decent number we reached, and this was also better than expected. So we can and that's also something where I would like you to be also a little bit prudent, not count with the same numbers on each and every quarter. Again, as stated before, there can be some volatilities depending on the business, depending on when CapEx are really expensed, depending on the timing on reimbursements. But overall, the improvement measures are on track, and I'm quite satisfied with the program and the status of the program.

So going in more details. Gross profit, as said, up EUR 24 million. Especially, volume-driven increase of gross profit in all 3 segments. In relative terms, we see better gross profit margins in Aftermarket and also Special Application and a lower margin in Auto, especially due to the lower capacity utilization compared to last year in preparation on the upcoming project ramp-ups we already discussed. Overall, a small increase also in the margin overall. So 27.7% is in line with our expectation.

On Page 9, R&D, a slight increase of EUR 8 million, in line also with our plans. So predominantly, the expenses related, as said also before, to booked business. And as also explained very detailed also in our last Investor Market Day, we are spending on R&D activities and try to explore on opportunities we see with the market trends. Some of you perhaps had the opportunity to be at the IAA. There, you would have seen then 2 of our demo cars with some new technologies which we have shown there and which are giving you an impression on what we are working on. R&D ratio is flat on a year-on-year comparison.

On Page 10, SG&A. Slightly up, especially higher distribution expenses most related to our Aftermarket business, which here is related to the opening of several branches in our wholesale business and is supporting growth in that business. And we see also, if you look at wholesale only, Aftermarket is certainly going, third-party sales is going up slightly by 2%. I will show that later. Wholesale is growing faster and certainly supported also by these investments we are doing. The ratio is improving slightly by 0.2%-points, so it's at 10.8%. If you look on quarterly development, this shows a very nice trend. But as stated also before, looking forward, we need also, and we are working on that, to invest also in our future system architecture, and that we are also doing. So that certainly adds to the strength also going forward. But for sure, we are trying really to realize also improvements where it is possible.

Page 11. EBIT overall, as mentioned before, increased by 5.6% to EUR 125 million. In addition to the explanations I did already, so the JV contribution is lower, but we expect not really this drop continuing. So basically, we are quite confident that we should not see overall a much bigger decline also in absolute terms compared to the number we have, certainly with some kind of an uncertainty about demands we will see in China and Korea. But for now, it looks quite okay. Margin slightly up, as said, 7.7%.

On Page 12, some more details on our P&L. Reported EBIT is at EUR 123 million, restructuring costs at EUR 1.8 million. These are related to, as last year to the ongoing restructuring programs in Germany. Net profit is more or less flat.

Perhaps 2 additional comments on tax and our net financial result. Tax this year or this quarter is more on a normalized level, especially if you compare it to last year or to the full fiscal year last year. Q1 last year was extraordinary low. Net financial result is slightly up because of higher investments, especially in our growth regions. We mentioned Mexico as one, which is certainly where we see actually also biggest growth, and we are hedging all investments done or financed out of Germany. And basically, the swap rates are booked here in net financial results.

Page 13. Free cash flow was up. And as I mentioned, a good and decent development, EUR 50 million, an increase in our funds from operation; but also, even with the higher sales number, a lower working capital. So it shows a good improvement. But again, there can be some volatilities, as stated, depending on the business activities. And we will carefully also decide especially on what is the best on the business also if we have some ramp-ups, if we then also increase perhaps stocks for a certain period of time to be secured also on customer demand. So there can be decisions which have, on a short-time base, a negative impact on working capital. But overall, we are working and quite confident on reducing our working capital, as set on a yearly base and over the 3-years period, by 3%-points.

Net CapEx is up. Dr. Breidenbach stated the investments in facilities, both in electronics but also in lighting; and with that, also in toolings, which are then also needed for the upcoming periods, upcoming projects and which will pay off also in growth going forward.

Jumping into the segments on Page 14. Automotive sales is up on reported numbers 5.9%. And as said, better than the markets in all 3 regions and significant growth in Asia and also in Americas. Profit is down in absolute and in relative terms. The reasons basically, we mentioned them before, 3: lower capacity utilization, higher invest in R&D and also lower JV contribution in that quarter. And the fourth reason in absolute terms is the FX effect I mentioned before.

Coming to Page 15, the Aftermarket external sales is up 2%. Overall, if you look at Aftermarket, total sales is down 1.6% mainly because of component sales related to industries and airport business, which was exited beginning of last fiscal year where we had still some sales in Q1 of last year, where, on a year-on-year comparison, this is not there any longer. So taking that out, and we see an increase of 2%.

We see a very good development in our independent Aftermarket business with 4.4%, and even higher growth rate in our wholesale business with 5.8%. Lower sales in our workshop products, minus 27%. But here, there was one onetime effect in the last year's first quarter, where we had significant sell of a new product, a new emission tester, where the approval was only in that quarter and there was a kind of onetime effect in that year, in the last year. EBIT over all is slightly up in Aftermarket at EUR 19.3 million, slightly up also in relative numbers to 6.4%.

Special Applications, as mentioned already, a nice top line growth, up 12.3%. And as stated before, good demand in all core businesses and also a good demand and even overproportional demand, especially in Australia with our production company there. And that overproportionality certainly supported also the strong EBIT we were able to show. But keep also in mind that we certainly also have in that year also compared to last year the extraordinary effect coming out of the disposal of airport and industries, which are impacting the results.

That's all from my side. And with that, I hand over to Dr. Breidenbach with the outlook.

Rolf Breidenbach^

Yes, thank you very much. With regard to the, let's say, overall market development, we see, let's say, a moderate positive growth. No noticeable tailwind from the market but also nothing which, from our perspective, is a -- lock to continue, let's say, the good start we, from our perspective, have shown in the first quarter with regard to growth also in the quarters to come.

We see Europe at a level of 2.6%. Germany, a little bit weaker but overall is 2.6%. NSA, flat, only a growth of 0.1%. So after a weak first half, we see better growth in the second half of our fiscal year. And a similar development in China. We see overall a flat development. This means an acceleration of a moderate growth in the second half. So as I said, no tailwind, but we already anticipated these market developments, and these were the basis of the guidance we have published, I think, 3 months ago.

When we look at the overall outlook with regard to our financial figures, we confirmed the guidance we communicated during the discussion of our last financial year figures. So sales growth, we expect at a level between 5% to 10% at an adjusted basis, so excluding FX effects. The same is true for the adjusted EBIT growth, and we still expect or targeted a margin of around 8%. So no change in the guidance to make this very clear.

To sum it up, we are very satisfied with both the growth level we have shown in the first quarter. And the same is true for the adjusted EBIT level. Of course, we now have the fact that due to the capacity extension, the construction of the new plant, the utilization in the overall plant network is lower. And therefore also, the gross profit we expect in Automotive will not be at this, let's say, record level we have achieved in the last fiscal year, but we are quite confident to at least improve it. And Special Applications and Aftermarket's stable business. Also, as Mr. Schäferbarthold has said, of course we have in Special Applications a special effect in the first quarter with regard to these Australian sales, but we expect also Special Applications at a very good growth level and very good EBIT level so that overall, we are very confident to overall reach both our growth targets and also our profitability targets.

Having said that, Mr. Schäferbarthold and I are looking forward to answering your questions.

Q&A

Operator^

(Operator Instructions) The question comes from the line of Viktoria Oushatova.

Viktoria Oushatova^

This is Viktoria Oushatova from Bank of America. I have 3 questions, please. My first question is related to your Special Applications division. So we saw significant growth in profitability year-on-year. I was wondering if you can give us more details on how much of this is actually driven by the recovery in the agriculture and construction equipment markets and how much is actually contributed by this increasing demand in Australian operations. And also, related to your Australian operations, is this a one-off effect? Or do you expect this to continue throughout the rest of the year? My second question is related to CapEx. So we've seen a very significant increase in CapEx levels, which now account for about 8.9% of sales. Could you maybe give us a bit of details on whether this is like a one-off level? Or what should we expect for CapEx levels going ahead for the rest of the year? And also, do you think you're still on track to meet your 7.5% midterm guidance level? And finally, my last question is related to the top line growth in lighting division. It seems like the revenues growth in lighting are still affected by ongoing projects' ramp-ups. So I was just wondering, when do you expect to actually see the positive effects from those projects' ramp-ups? And if you can maybe give us more details on which product categories they relate to in lighting.

Rolf Breidenbach^

With regard to Special Applications, please understand that I cannot comment on the profitability level of more specific segments or, let's say, special operational activities. But your question asked for whether there are one-offs in the first quarter, yes, there are special effects. And let's say in the perspective of the whole fiscal year, we see a profitability level of Special Applications between, let's say, 9.5% to 10%, yes. So a good profitability but not this outstanding profitability as in the first quarter. With regard to lighting, when we talk about ramp-ups, we are especially talking about LED, full LED headlamps in all the regions. Of course, there are a lot of ramp-ups going on and also end of productions and we see no, let's say, interruption or special activities this fiscal year. And we are, so far, quite satisfied with the growth rate in lighting, and we see a good growth dynamic also in the quarters to come.

Bernard Schäferbarthold^

In respect to CapEx, we are still, I would say, confident to reach the 7.5%. There's one point I have to add, that is the reimbursements, there they are significant reimbursements, we expect also, especially late Q3 and Q4, where this is also depending on customers and start of production of our customers, when these reimbursements are really then paid and that we do not really have only in our hands. So that's where a certain uncertainty is, because these are deducted then in the net CapEx. But overall, we are still, I would say, quite confident to be around that number.

Operator^

Your next question comes from the line of Lello Della Ragione.

Lello Della Ragione^

I have actually just one which relates to the statement that you did on the gross profit margin. In the report, you mentioned that you felt the effect of lower capacity utilization given the start of contracts that we look or just later during the year. But I was wondering, especially considering the last comments that you made on the Automotive in particular, should we see an improvement over the reminder of the year in terms of gross profit margin of the Auto division? And looking, you said, at the gross profit margin of the other, so Special Applications and Aftermarket, do you think that the level that you reached in the quarter is sustainable? And summing up, you mentioned some headwinds that affected the overall group figure. Did you have some tailwind, you said, that counterbalanced somehow the effect of lower capacity utilization?

Rolf Breidenbach^

Yes, as I said in Special Applications, we have this special effect. Therefore, the gross margin will go, considering this, a little bit down in the quarters to come so for Special Applications. With regard to Automotive, we expect an increase in the gross margin because this underutilization step-by-step can be improved. But it will, of course, not reach the level we've shown in the last fiscal year. Because in the last fiscal year, all our plants were highly utilized. It was a special situation. And in this fiscal year, as I said, we are building up a lot of plants and that you can imagine there are a lot of fixed costs; support people are onboard without the corresponding sales. Therefore, we will see an improvement but not this record level that we showed last fiscal year. In Aftermarket, I think the growth number we are showing today, we also expect in the quarters to come, approximately.

Lello Della Ragione^

Okay. And if I can have another one just on R&D. I understood that the 10% is a high level. I mean, is it also related to the fact that sales are not as high as the other quarter? But I was wondering, looking at R&D overall expenditure in terms of amount, is it fair to assume that EUR 160 million, EUR 170 million per quarter is a fair assumption to make just for modeling purposes? Or you have no visibility at this point in time on that line?

Rolf Breidenbach^

Yes, I think you can rely on our guidance we have given also in the last call. So it's a figure of around, let's say, 9.7%, 9.8%. It's something we think we can achieve, taking into consideration that the growth will also, let's say, now come in the next quarters. We know that this figure is very high. But perhaps all of you who have visited the IAA perhaps could see that we are significantly investing into autonomous driving, into energy management, into connectivity. And therefore, our strategy remains the same, and I think it's a figure which can be considered, as we have seen, let's say, a level between 9.7%, 9.8%, approximately. So a little bit lower than what we have shown in the first quarter.

Operator^

Your next question is from Christian Ludwig.

Christian Ludwig^

First of all, you did a remarkable effort in reducing your working capital. Is this -- some of it, you believe, is going to be sustainable throughout the rest of the year? And second question, Mr. Schäferbarthold, when you joined, you said one of the things that you will have a stronger focus on than maybe in the past is in M&A activities. So far, we have not seen any M&A activities. Is this something that there may be trends that we would see happening in the course of this fiscal year?

Bernard Schäferbarthold^

Well, on the working capital, as I said, it's on one hand side, it's not really a sprint, it's more a marathon. So and then that was when I commented that all the measures basically I'm quite satisfied about the program and the achievements. So we are really working on a lot of very good measures through the overall value chain, as I explained before. I think it's too early now to say the level we have now and we will now see quarter-on-quarter the same improvements. I think already, we see some kind of or I can feel the focus also in the company. And it's not only because I'm there, it was already started before. But we see now some improvements. But again, there can be volatilities on a quarter-by-quarter level. Over the full year, still our expectation is that despite volatilities which can happen, we will see working capital going down. That's our view now.

Rolf Breidenbach^

With regard to M&A, we are continuing screening the market. We are in discussion with a lot of targets. But the situation doesn't really change that we currently see a very high price level. And when the business case is not paying off, we are not buying. And so this is one part of my answer. The other part is we are currently, from our perspective, quite successful in building these open cooperation. Perhaps you know we have these kinds of working together with ZF and NVIDIA in the field of autonomous driving. We have now buildup in open cooperation with BreezoMeter in the area of air quality sensing. And from our perspective, a lot more will come. And this kind of very focused customer solution cooperation is a good lever for us to compensate the currently for us missing opportunity in doing M&A acquisition, especially in the field of electronics. So overall, we are very intensively screening the market. A lot of activities are going on. But I'm sure in the, what should I say, years to come, we will do some M&A but only when the price is at a reasonable level. And as I said, this open cooperation approach seems to be, today, especially in electronics, let's say, more successful and delivers us in a shorter time, more benefits and results.

Operator^

And your next question comes from the line of Ashik Kurian.

Ashik Kurian^

I've got 3. The first, just trying to understand your capacity ramp-up a bit better. So I believe from your release you're building 4 new plants. How much of capacity does this address? Or in other words, does this satisfy your targeted growth until 2020? Or should we expect similar capacity ramp-up issues in the coming years as well? And then the second question is on the FX transaction. Now you seem to highlight that the FX had a negative impact on the margins. If I remember right, a couple of years back when FX was a tailwind on revenues, you had also highlighted that it was a headwind to the margins because of the hedging that you've used. So what does that mean, is FX tailwind on, it seems to me that you have a headwind on margins either way even if FX is positive or negative. And maybe if you can clarify that. And then lastly, on your outperformance by region, seemed steady outperformance in Europe really hasn't stepped up. Is that going to be the case going forward where you think you've reached a saturated market share in Europe and the outperformance has to come from North America and Asia? Or will we see outperformance accelerating in Europe in the coming years?

Rolf Breidenbach^

Coming to your first question with regard to this increase of capacity and building up of plants, my rough estimation is with regard to electronics, and here we are building up these 4 plants, this should, let's say, help us to produce the business on hand and what we will acquire until the end of the calendar year 2021. So it's really a special situation that we are building up such a number of plants in one fiscal year. And therefore, the utilization step by step, of course, will improve.

Bernard Schäferbarthold^

In FX, the relative margin is not impacted. The absolute number of EBIT is impacted because the Dollar and that is related especially to our business in the Americas but also our Chinese business in Renminbi due to the weaker currency, and this was different, especially if you look at last year, also the year before was supporting basically the EBIT. And now we see that, especially with a very significant drop down of the U.S. dollar, we see a negative impact. And this is roughly the 2% I mentioned. On top of that, and that relates also to your question about the growth and where growth happened, we see more and more growth outside of the Euro, I would say, so that there's much higher exposure to and especially to Renminbi and to U.S. dollar so that this effect is a little bit larger than also compared to last year's. But there's no transactional significant effects now.

Rolf Breidenbach^

And that's partly also answer your third question with regards to Europe and our growth perspective in the other regions. So of course, we would like to balance out the different markets. And therefore, from a strategic standpoint, we would like to grow much faster in Asia and also in NSA compared to Europe. On the other hand, of course, it remains our target to outperform the markets in all the regions. But of course, the pattern is clear. The growth rates in NSA and Asia from a strategic standpoint should be higher than in Europe.

Operator^

And your next question comes from the line of Christian Breitsprecher.

Christian Breitsprecher^

It's Christian Breitsprecher of Macquarie. I wanted to come back to the margin development in the Automotive business. And the way I understand it now is that the operating margin that we've seen in the last fiscal year was actually, yes, kind of unusually good. Now we have this the ramp-up issue that will be extending more than just this fiscal year. So do I interpret this correctly that before the fiscal year 2020, we shouldn't dream of the Automotive margin getting back to the 8.9% that we've seen in the last fiscal year? And the second question is with respect to the at equity result. I mean, there, we have seen a drop in the first quarter. Can you explain a little bit what's behind it and what's happening there with production ramp-ups? Is that also impacted by that? And what is their your perspective for the rest of the year?

Rolf Breidenbach^

So with regard to Automotive, we see a good chance to step by step come closer to our, let's say, very good figure in the last fiscal year. So we do not expect this utilization topic to be so significant in the years to come. And I already expect an improvement in the months to come. Therefore, in the midterm we of course, it's our target to again reach the gross margin also or gross profit in Automotive we have shown in the last fiscal year. Utilization will not be on our side, but we see other levers to step by step compensate that.

Bernard Schäferbarthold^

At equity, as I said also before, we have seen a lower demand, especially on Korean but also on the Chinese joint venture because of lower demand of Korean OEMs. We see and that was my comment that this is not continuing in that extent, as we have seen it in Q1, so that basically, we are quite confident that this gap you have seen in Q1 and if you would now extrapolate it to the full year, we should not see a much larger deviation compared to last year. But still, I would say, as I mentioned, it's basically the view we have now and some kind of an uncertainty, but it seems to stabilize.

Christian Breitsprecher^

Maybe to follow up on that. This was then just really an issue of kind of lack of demand, but it was not an issue of operations?

Bernard Schäferbarthold^

No, there were no ramp-ups. That was a pure demand question in that quarter.

Operator^

(Operator Instructions) No more questions. Please continue. Thank you.

Rolf Breidenbach^

Okay. Then thanks very much from Mr. Schäferbarthold and my side for taking the time, for the interest in our company, for the interesting questions. I wish you all the best. Thank you.

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