C: Dr. Rolf Breidenbach; HELLA GmbH & Co. KGaA; CEO and President
C: Bernard Schäferbarthold; HELLA GmbH & Co. KGaA; CFO
P: Christoph Laskawi - Deutsche Bank AG, Research Division – Research Analyst
P: Gabriel Adler - Citigroup Inc., Research Division – Assistant VP& Senior Associate
P: Operator

COMPANY EDITED TRANSCRIPT

Operator: Dear ladies and gentlemen, welcome to the investor call of HELLA for the results of the first half of 2021/2022. At our customers' request, this conference will be recorded. (Operator Instructions) This call is hosted by Dr. Breidenbach, CEO; and Mr. Schäferbarthold, CFO. May I now hand you over to Dr. Breidenbach, who will lead you through this conference. Please go ahead, sir.

Rolf Breidenbach: Yes. Thank you very much. Dear, ladies and gentlemen, good morning to all of you. And of course, a happy new year. I hope you put -- start well into 2022. Thanks a lot for dialing in, and welcome to the HELLA investor call on the first half of the fiscal year 2021/2022. As always, also, of course, a warm welcome on behalf of my colleague, our CFO, Mr. Schäferbarthold.

Before we start with our presentation, I would like to make some general remarks as always. Let me start with the market situation. The market environment from my perspective remains weak. Our second quarter was very poor with automobile production down by around 21%. We also do not see any recovery in the first months of 2022, mainly due to semiconductor shortages, but also interrupted logistics chains and yes, and also corona-related constraints. The market will remain, from my perspective, very challenging. Thus, we do not expect any recovery in the second half of our fiscal year which we had assumed months ago. We already communicated this in our last call at the end of November, as you know.

We have not seen any further deterioration of the market environment since then. The current forecast from IHS of December 2021 predicts around 3 million more vehicles in the second half of our fiscal year compared to the first one. From our perspective, this is more a best-case scenario. This gives us a range of approximately 71 million to 75 million vehicles produced in 21/22, which is a significant deviation compared to the assumption made at the beginning of our fiscal year. At that time, we had assumed around 85 million vehicles.

Coming from the market situation now to our actual business situation. In the view of the challenging market environment, from my perspective, we can be quite satisfied with our sales performance in the first 6 months of our fiscal year. With a decline in sales in automotive of around 5% we were able to significantly outperform the market. This, again, is a confirmation of our good strategic orientation.

We outperformed the market in all regions, Europe, North and South America and Asia. In particular, in China, we were able to further enhance our market position and outperform this region by nearly 44 percentage points. That, of course, is also very important with regard to our strategic development with regard to the balance of our business in the different regions and also with regard to our positioning of our automotive business in China, because we see China not only as a very important growth engine of our business but also as an important shaper of many automotive technologies. Therefore, as I said, we are very, very satisfied with the development of our Chinese business.

With regard to our results, our results were negatively impacted by various factors. We have already commented on these in detail in previous calls. We continue to see a significant burden on our operations, the high volatility of customer call offs leads to stop and go production. And of course, this is then accompanied with significant efficiency losses. In addition, the general decline in sales is reducing our capacity utilization and flexibilization of our resources is currently, unfortunately, therefore only possible in a limited extension.

Profitability is also being impacted by material and logistic price increases as well as higher energy costs. In addition, we are also facing increased research and development expenses due to the huge acquisition volume of the past years. We now have to develop these many projects and makes them launch-ready, and this is currently impacting our automotive business in particular.

We continue to enforce further improvements, for example, through redesign to cost and other measures in order to lower development expenses and also to reduce material prices. And we will also continue our strict cost management to keep general administrative and selling expenses as low as possible.

Our Aftermarket and Special Applications segment developed very positively in the first 6 months of our fiscal year. Both segments increased sales and earnings. The Aftermarket recorded strong spare parts and workshop businesses, while the Special Applications segment benefited from good business for agriculture and construction machinery.

Our cash flow showed a clearly negative development: Next to the low level of earnings this was also especially due to the development of our working capital. The main driver was a significant buildup of inventories as a result of orders from our customers, which were not picked up. We are contractually obliged to purchase the corresponding parts for the ordered volumes regardless of whether the customer ultimately calls off the order parts or not. And from our perspective, we will not see a significant reduction in working capital until the market environment or the prevailing bottlenecks normalize.

As already commented in our last calls, CapEx will remain at a high level as we need to invest into product-specific equipment, our worldwide network and our automation initiative. And it's not our intention to reduce this because we will need these investments on our global footprint to improve our efficiency. And of course, we need the product-specific equipment to launch the many orders we have acquired.

Let me now shortly comment on our outlook for the current fiscal year in the view of the business performance to date, the expected lack of market recovery in the second half of the year and increasing cost burdens. We have already further lowered our sales and earnings forecast on November, 29th. So we are expecting for the current fiscal year '21/'22 a currency and portfolio-adjusted sales in the range of around EUR 5.9 billion to EUR 6.2 billion. And we expect an adjusted EBIT margin of around 3.5% to 5.0%. Previously, we expected currency and portfolio-adjusted sales between EUR 6.0 billion and EUR 6.5 billion and an adjusted EBIT margin between 5 to 7 percentage.

With regard to the start into our third quarter, this was, let's say, a quite good start. Nevertheless, we are currently facing additional burdens due to the

lower production volumes and the further price increases. We are working on agreements with our suppliers and also on clauses in our customer contracts to recoup additional costs. As mentioned already, we have started negotiations with nearly all our customers and the discussions are very constructive
I have to say. For the current fiscal year, we do not see, let's say, meaningful effects in our P&L to date, but the results of the negotiations are expected to have a positive impact beyond this fiscal year.
Currently, we see HELLA developing more towards the upper end of our forecasted range, but the uncertainties in the coming months remain, from our perspective, very high, especially with respect to the fourth quarter. The development of volumes and the volatility in this quarter will be decisive for where we will end up in our forecasted range.
Allow me at last a comment with regard to our overall strategy. I would like to emphasize that HELLA's overall strategy remains intact. The demand for our product and technology portfolio is very solid. Our position in the market and our position with customers are very strong. We will, therefore, continue our profitable growth path and continue to outperform the overall market. This is our clear target. However, we expect the burden of the shortages to continue into 2023. Furthermore, the general price increases, not only for materials but also for energy and personnel are burdens we did not see a year ago. This will negatively impact our business in longer term. We will therefore work step-by-step in the coming time to bring our profitability back to the level of 8%, which we have already seen in the past.
Having said this, allow me to move to Page 4 of our presentation, starting with our financial results for the first half of our fiscal year 2021/2022. Our currency and portfolio-adjusted sales decreased by 2.6 percent. Our adjusted EBIT decreased by 42% to EUR 156 million. And thus, our adjusted EBIT margin is at a level of 5.1%. This is a decline of 3.5 percentage points compared to the first half of the previous year.
Our reported EBIT margin is at a level of 4.9%. This includes restructuring costs mainly for the improvement program in Germany. Our adjusted free cash flow decreased by EUR 187 million now to minus EUR 203 million.
At Page 5, we give you an overview of our automotive performance in the single regions. You can see that we were able, as already said, to outperform

the global automotive market in all regions and especially in Asia. In Europe, our outperformance was strong. We outgrew the market by around 15 percentage points, mainly due to SOPs in lighting. In North and South America, we outperformed the market by around 4 percentage points. The outperformance here was positively impacted by a low comparable basis. And in Asia and the rest of the world, we significantly outperformed the market by 38 percentage points. This is mainly due to a very strong performance in China. We communicated already in our last call that we expect several SOPs in China that are still ramping up. So all in all, on a global level, our automotive business outperformed the market by 10.5 percentage points in the first half of our fiscal year 2021/22. Having said this, let me now hand over to my colleague, Mr. Schäferbarthold to provide you with more details.

Bernard Schäferbarthold: Let's continue on our presentation on Page 7. So overall, in terms of sales and also adjusted EBIT, we confirm with the presented numbers the preliminary numbers we already communicated end of November. If we look at sales in the first half, FX and portfolio-adjusted sales are at EUR 3.0 billion: That respectively is a decline of minus 2.6% compared to previous year. The FX effect is insignificant, and there are no portfolio adjustments in the first half. Positively, as mentioned, in our segments Aftermarket and Special Applications, we have grown significantly in comparison to prior year. In Auto, as said, we were able to outperform the market significantly in the first half by 10.5%. And as Mr. Breidenbach also mentioned, our start also into the third quarter was good, and we had also a decent outperformance looking also at the month of December.

Overall, in terms of sales, there were some positive results in the first half. But as said, we are significantly below our internal expectations we had at the beginning of our fiscal year, and the situation remains very challenging regarding the bottleneck on semis and/or what is related to that if it comes then to operational topics, which we are working on due to that topic.

Coming to Page 8. Our gross profit declined in absolute terms by EUR 37 million to around EUR 745 million. In addition, our gross profit margin decreased by 0.7 percentage points to 24.5%. On one hand side, the decline in sales led to lower utilization of our plants compared to previous years. In addition, we had in the first half high reimbursements. And also, as also already commented in Q,1 overall in H1 lower project-specific costs.

We see additionally that all COVID-related measures and the bottleneck situation on semis had a high burden on our cost structure. Stop-and-go, broker costs and additional freight costs were significant and have increased also in the second quarter and remain at a high level, still now in the third quarter, which started. We expect this bottleneck situation to remain very challenging also in the full second half of our fiscal year. We see that a certain improvement should most probably only occur in the second half of this calendar year 2022.

If we go to Page 9, the R&D expenses increased by EUR 41 million. We still remain very focused on R&D activities related to projects which are already acquired and where we are now in preparation to serious development and production ramp-ups, which should now occur and happen in the upcoming periods.

The high level now of R&D reflects the strong order intakes we had, especially in the last 2 to 3 years. We also commented with record order intakes, which we had in these last years. Our R&D ratio increased to 11.1% in comparison to prior year. We expect the R&D ratio also for the full year to be above the 10% level we have set as a target for ourselves due to the lower expected sales development on the full fiscal year.

Coming to the SG&A cost on Page 10. The SG&A costs increased to EUR 265 million. We maintain our stringent cost discipline. One comment perhaps to the previous year. There within the SG&A cost we had a EUR 19 million positive gain due to an impairment release on our Korean joint venture. If we would take that apart, our SG&A level in the second quarter was at a comparable level to previous year. This, I think, shows how disciplined we are, and we will remain this discipline also in the upcoming periods.

If we come to Page 11. Our adjusted EBIT, as said, is at EUR 156 million. The EBIT margin decreased to 5.1%. This due to lower sales level and the high additional cost mentioned plus the investments in R&D. The reported EBIT is at EUR 149 million. We have low adjustments overall net in the first half, and this led to increase in our reported EBIT due to the high accrued provision in prior year.

On Page 13, we have some selected highlights on the second quarter related to our sales growth and adjusted EBIT margin performance. The second quarter shows a significant decline in sales in the auto segment due to the very poor market development. Therefore, with the mentioned additional cost, the auto EBIT margin declined significantly to the low level of 2.3%. In Aftermarket and Special Application, we again performed very decently in the second quarter in terms of sales and also EBIT performance. We expect in both of these segments a good development also in the second half of our fiscal year.

On Page 14, we have here our adjusted free cash flow, which is significantly negative at minus EUR 203 million in the first half. This is certainly very disappointing for us overall. The negative number came or comes out of a significant inventory increase we had. Mr. Breidenbach mentioned the very high customer demand in our systems. And on the other hand side, the very high volatility also, let's say, to the deliveries we had, and the contractual situation forced us to be ready to deliver, and that's the reason for this high inventory level we have, which impacts us significantly after the first half of this year.

That's certainly something which will continue to impact our free cash flow development also in the second half. And with the challenging semi situation also in the upcoming months, we do not expect a significant normalization now so that overall free cash flow will remain at a low level. In this full fiscal year we do not expect any significant improvement to happen in the second half.

On Page 15, looking to the segments. Automotive sales are 4.9% lower in comparison to previous year. It's as said, a solid -- a good outperformance. But as mentioned, the sales level is by far lower than we expected. And profitability in auto set decreased to EUR 92 million, 3.6%.

Aftermarket had a continuous decent sales development with a growth rate of 16% and overall good development if it comes to our overall product portfolio. Also our workshop products had a strong demand with our customers. With that, the profitability increased in Aftermarket very positively as shown to EUR 33 million, 11.8% of EBIT. Same on Special Applications, this segment also performed as said, very solid and had a good EBIT with EUR 32 million and a strong EBIT ratio of 17% on the first half. Having said that, I hand back to Mr. Breidenbach with the outlook and happy to take your questions afterwards.

Rolf Breidenbach: Yes, Mr. Schäferbarthold. Thank you very much.

And so a short look on the automotive market. As already mentioned, Q2 for 21/22 was very weak with minus 21.4%. Q3 will remain weak with minus 8.2%, and Q4 was plus 2.6% as I said is from our perspective, a more best case scenario. Overall, IHS is expecting a decline of 9.2% for the global light vehicle production. The most significant market decline they expect in Europe with more than 16% following by North and South America and Asia.

I already comment on the company outlook. I mentioned this EUR 5.9 billion to EUR 6.2 billion currency and portfolio adjusted group sales forecast. The reasons I think were also already mentioned by Mr. Schäferbarthold and myself, the resource bottleneck situation on the one hand and also the insecurity with regard to COVID are behind this sales outlook. Our adjusted EBIT margin also mentioned already from my side between 3.5% to 5% here. Allow me to again point out the burdens we are seeing with regard to material cost increase, higher logistic costs, higher energy costs, the not ideal utilization of our plants, the stop and go inefficiency we are currently facing. These are, of course, negative factors we are facing. As I said, we have started and implemented countermeasures, but so far, of course, full compensation is unfortunately not possible.

At the end, allow me to also make a short remark on the Faurecia topic. We are expecting the pending merger control clearance in the near future, after which the closing will take place. Based on Faurecia's current shareholding ratio HELLA and Faurecia will continue their operations with each party's dedicated management teams and decision bodies. Therefore, HELLA Management Board will remain fully responsible for the business and strategy execution. As of now, there are basically no changes to the Lighting, Electronics, Aftermarket and Special Application strategy.

In the coming time, we will focus on the most beneficial areas to both parties. First, to quickly utilize synergies. Specific agreements will be defined or will define the legal frame on how to achieve these synergies after closing, also ensuring a fair allocation of synergies between Faurecia and HELLA. In case there are areas to create synergies or other areas to cooperate, we will do that if it's in the interest of HELLA. In case there are some reporting necessities to Faurecia or other things which are mandatory, we will comply with all legal requirements. And in case there are disadvantages for HELLA, we will make sure that these disadvantages are compensated. Yes. Having said this, Mr. Schäferbarthold and I are now happy to take your questions.

Operator: (Operator Instructions) The first question is coming from Gabriel Adler at Citi.

Gabriel Adler: Gabriel Adler from Citi, and I have 3 questions. The first, could you please quantify the impact that you expect from cost inflation per month from logistics and raw mats as you have done in the past? And can you comment on the level of wage inflation as well you're expecting for the next year? And secondly and related to that, maybe you can provide a little bit more detail on those negotiations you're having at the moment with your customers regarding price recovery?

And could you help us understand approximately what portion of the cost inflation, the business faces, you think that you can recover? And why you only expect this to impact the next fiscal year? And then my final question is on free cash flow. Do you still think it's possible to generate positive free cash flow in the second half if the supply chain is volatile? And just some clarification around the free cash flow comments you provided.

Bernard Schäferbarthold: To your first question, so we have seen now that the increase in costs, and we commented a bandwidth of EUR 15 million to EUR 20 million of additional cost that this is what we expect. And we have now seen in the last recent months that we are now coming into that range and that at least now for the upcoming months, we expect to be at the higher end and even -- it could even be that we will surpass that in single months depending especially now on the further development of the cost positions. And this depends strongly also on a further, let's say, development on logistic costs. This is one element. And the second most relevant related to the increase is coming out of price increases from our suppliers and there especially on the electronic parts, which still are, for some, in negotiations, but from some suppliers now price increases now starts with the month of January, so with the new calendar year. And that's why here also, we expect some higher costs. On the other hand side, we now limit, let's say, what we are buying from brokers. And if we buy from brokers, then we do it in agreement also with our customers so that there is a share of this burden. In addition, you also asked, we see partially that energy costs are also increasing. So a large part, at least from today's perspective, was still hedged. But in some areas, now the part of the non-hedged parts within the upcoming months is increasing, so that there is also a burden of energy cost increases, which are happening.

And coming to the wage increases, here, we see that especially in some areas and countries, for example, in some countries in Eastern Europe, but also in India and China, the increase in wages is higher in comparison to last year. So here, we are at, let's say, higher in average at a high single-digit percentage point of increase in wages, which for most now also is coming into place now also from January 1. And that's why here also, we expect a higher cost level.

In terms of free cash flow, we do not see now that in the third quarter we should improve. It's still the volatility and, let's say, the difference in terms of customer demand in comparison to deliveries. There is still a very high gap so that the inventory levels remain at least, if I look at it from now January, for today's perspective is still very high. So that Q3, I do not see any, let's say, improvement now. If it comes to the working capital situation, we should not see, let's say, such high negative development again. But I would overall assume that we hope that in H2, we should see some improvements especially coming -- or could come from our fourth quarter. But as Mr. Breidenbach said, if we should see an improvement in terms of sales immediately, we would then see that inventories could come down, and this will immediately have a very high impact on our free cash flow. You have seen that also in the second quarter of our last year, where we started in the first quarter with around minus EUR 200 million, and then there was a very big swing into the other direction, more or less with a plus EUR 200 million from one quarter to the other. So there you have perhaps seen in the past how fast this can go.

And this is why we also commented in a very positive case we could then, let's say, turn this around what we have in the first half and in the very, very best case, even bring it back, let's say, to a black zero: But it's very difficult to predict because this really depends on when this uptick in sales will happen and if it will come early enough looking at our fiscal year ending end of May that this can then turn in cash

Rolf Breidenbach: Coming to the customer question, customer negotiations, I cannot go too much into detail due to confidentiality reason, but what I can say is that we are negotiating with all our important customers. No negotiation has stopped. It's even the other way around. We have achieved first agreements for specific parts and regions and time frames. We are negotiating compensation for 2021 as well as for 2022. And we expect a compensation on a quarterly basis in some of the contracts. Others are paying lump sums. And it's currently very difficult to say how much of our material cost increases will be compensated. But let's say it this way, we were positively surprised by the openness of our customers to discuss these topics and to really go into the details and talk about specific agreements. But it's a little bit too early to assess the financial impact for this fiscal year. My assessment: it will be not so significant. But for the next fiscal year, there should be a reasonable amount, which will be compensated.

Operator: The next questions are coming from Christoph Laskawi of Deutsche Bank

Christoph Laskawi: Christoph Laskawi, Deutsche. The first one will be on the comments that you had a good start into Q3. Is that related more or less to volumes overall or just lower volatility? And was the good stance spread across all regions or primarily in one? And following up to that, does your comment from the last call still stand that Q3 will be below Q2 in margin terms? Or is it too early to comment?

And then essentially a follow-up to your comments on the Faurecia deal. When it comes to accounting changes in the sense that you will adjust your fiscal to calendar year, will you do that post the current fiscal year? Or are you planning to provide for Faurecia with numbers just especially to their fiscal year? If you could elaborate on that? And also Faurecia commented that they want to move Clarion into the electronics that you have once the deal is fully done. Are you having talks on how that could be essentially completed in the current ownership structure with Faurecia having 80%? Or is that also too early to comment?

Rolf Breidenbach: Yes. Allow me to start with your first question. Let's say the good start into Q3 is related to an overall better volume development we have expected in December and also in the last days of November. And this is true for both Lighting and Electronics and for more or less all regions. We don't know whether it was a kind of year-end really or really a slight improvement of the overall sales development. Let's see.
With regard to the profitability level, usually, Q3 is one of our weakest quarter. Therefore, no change with regard to the assessment currently. Perhaps it's also here a little bit too early to really comment on that. But currently, no change in our estimations that Q3 will be weaker than Q2

Bernard Schäferbarthold: Yes, in terms of accounting changes, we are not planning HELLA to do any accounting change in this fiscal year. But for sure, we will then provide some closing onwards numbers to Faurecia that they are able to consolidate the numbers and within the accounting principles they are using. So especially to do one example on the capitalization on R&D, they are capitalizing at a higher degree, and this is certainly something where… In general, you could say that the result should be a little better in terms of what then Faurecia is showing than numbers we would (then) show.

Rolf Breidenbach: With regard to this Clarion topic, it's too early to comment on that. But as I said, in the case there are disadvantages for HELLA, we will make sure that these disadvantages are compensated. When things are agreed, we will make sure that with specific agreements, which have to be defined, we make very sure that we are legally and also with regard to the interest of HELLA on the safe side. But the Clarion topic is by far too early to comment on.

Bernard Schäferbarthold: I would perhaps add one comment to our Q3 expectations. Just in addition to what Mr. Breidenbach said. So it's still, let's say, a little early, but take our comments that we said we had a good start and a lot now really depends on January and February. So that actually, in general, we can say that we are more to the upper end of what we expect in our guidance from what we see. And this certainly would also have an effect on Q3, where still there is a risk that we can fall down at January and February would not be as good, but there is, let's say, a higher opportunity compared to end of November that it could also be better and especially in comparison to Q2, which would not fall down. But still too early to have a very, let's say, more precise view.

Operator: (Operator instructions) There are no new questions coming in. For closing remarks, I hand back to speakers.

Rolf Breidenbach: Yes. Then I have to thank again all of you for participating in this call. Thanks very much for your time, for your questions. And yes, again, I wish you a good start into 2022. All the best. Bye.

Operator: Ladies and gentlemen, thank you for your attendance. This call has been concluded. You may disconnect.

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