Howmet Aerospace Inc. (NYSE:HWM) Q2 2022 Results Conference Call August 4, 2022 11:30 AM ET

**Company Participants**

Paul Luther - Vice President of Investor Relations
John Plant - Executive Chairman and Chief Executive Officer
Kenneth Giacobbe - Executive Vice President and Chief Financial Officer

**Conference Call Participants**

Kristine Liwag - Morgan Stanley
Noah Poponak - Goldman Sachs Group
Gautam Khanna - Cowen and Company
Robert Stallard - Vertical Research Partners
David Strauss - Barclays Bank
Matthew Akers - Wells Fargo Securities
George Shapiro - Shapiro Research
Seth Seifman - JPMorgan Chase
Philip Gibbs - KeyBanc Capital Markets
Michael Ciarmoli - Truist Securities

**Operator**

Good morning, ladies and gentlemen, and welcome to Howmet Aerospace Second Quarter 2022 Results Conference Call. My name is Ian, and I will be your operator for today. As a reminder, today's conference is being recorded for replay purposes.

I would now like to turn the conference over to your host for today, Mr. Paul Luther, Vice President of Investor Relations. Please go ahead.

**Paul Luther**

Thank you, Ian. Good morning, and welcome to the Howmet Aerospace Second Quarter 2022 Results Conference Call. I'm joined by John Plant, Executive Chairman and Chief Executive Officer; and Ken Giacobbe, Executive Vice President and Chief Financial Officer. After comments by John and Ken, we will have a question-and-answer session.

I would like to remind you that today's discussion will contain Forward-Looking Statements relating to future events and expectations. You can find factors that could cause the Company's actual results to differ materially from these projections listed in today's presentation and earnings press release and in our most recent SEC filings.

In addition, we have included some non-GAAP financial measures in our discussion. Reconciliations to the most directly comparable GAAP financial measures can be found in today's press release and in the appendix in today's presentation.

With that, I would like to turn the call over to John.

**John Plant**

Thanks, PT, and good morning, everyone. Welcome to our Q2 call. Howmet's second quarter was another strong quarter and witnessed the continuing recovery in commercial aerospace, which was up 34% year-on-year and 7% sequentially.

Total revenue was $1.393 billion and was up 17% year-on-year and 5% sequentially, which was at the top end of our guidance range. Revenue increased in each business segment, both year-over-year and sequentially. Similarly, Howmet's Q2 EBITDA grew year-over-year and sequentially to $316 million, including net headcount additions of approximately 740 employees.

Moreover, we are particularly pleased with the continuing healthy EBITDA margin performance of 22.8%, which is also at the high end of guidance. Inflationary costs were either recovered from customers or offset with efficiency improvements. Finally, earnings per share was strong at $0.35, an increase of 59% year-over-year.

Moving to the balance sheet and cash flow. Free cash flow was a positive $114 million in the quarter, including an inventory build of approximately $105 million, primarily to accommodate the commercial aerospace recovery.

Free cash flow was positive for the first half, and we expect to have positive free cash flow in both Q3 and Q4. The cash balance at the end of Q2 increased to $538 million, including common stock repurchases of $60 million and bond repurchases of $60 million.

Share and bond repurchases were with cash on hand and continue to reduce share count and interest expense drag and hence improved free cash flow yield. Legacy pension and OPEB liabilities are trending favorably with a net liability improvement of 60 million year-to-date.

Associated cash contributions are down 65% in the first half compared to last year. Lastly, net leverage improved to three times and is expected to accelerate by year-end to move towards 2.5 times EBITDA.

Segment details will be covered by Ken. However, I would like to note the small continuing EBITDA margin increase in our engines business and an improvement in structures. This was commendable of structures in the light of both the inventory burn down of F-35 and the continuing low to zero build of the Boeing 787. Now over to Ken.

**Kenneth Giacobbe**

Thank you, John. Please move to Slide 5 for an overview of the markets. Second quarter revenue was up 17% year-over-year. The commercial aerospace recovery continued in the second quarter, with commercial aerospace revenue up 34% year-over-year and 7% sequentially, driven by the Engine Products segments and the narrow-body recovery. Commercial aerospace 45% of total revenue, and although an improvement from 2021, we continue to be far short of the pre-COVID level, which was 60% of total revenue.

Defense aerospace was essentially flat year-over-year as well as sequentially, driven by continued customer inventory corrections for the F-35. Commercial transportation, which impacts both Forged Wheels and Fastening Systems segment, was up 19% year-over-year and 11% sequentially, driven by higher aluminum prices and higher volumes.

Finally, the industrial and other markets, which is composed of IGT, oil and gas and general industrial, was down 4% year-over-year. Going deeper into this market, IGT was essentially flat, oil and gas was up 24% and general industrial was down 20% on a year-over-year basis.

Now let's move to Slide 6. So let's start with the P&L with a focus on enhanced profitability. In the second quarter, revenue and adjusted EBITDA were at the high end of guidance as both metrics were up 17% year-over-year.

Adjusted EBITDA was $317 million. Adjusted EBITDA margin was also at the high end of guidance as it increased 10 basis points sequentially to 22.8%. Excluding the $60 million year-over-year revenue impact of higher material pass-through, EBITDA margin was 100 basis points higher at 23.8%.

Adjusting for material pass-through, the flow of the incremental revenue to EBITDA was in-line with expectations at approximately 33%. We have been able to maintain our strong margins despite the impact of higher material pass-through and inflation as well as headcount additions to support future growth.

During the second quarter, we continued the recruitment of headcount by approximately 740 employees, including net additions of approximately 455 in engines and 245 in fasteners as preparations are made for continued growth in the second half, adding to the growth already experienced in Q2.

Year-to-date, we have increased headcount by more than 1,200 employees, and that has been focused in engines and in fasteners. Adjusted earnings per share exceeded the high end of the guidance at $0.35 per share, up 59% year-over-year. For the quarter, the impact of foreign currency on earnings was minimal.

Moving to the balance sheet. Free cash flow in the second quarter was a positive 114 million, which excluded 44 million of proceeds generated from the sale and associated leaseback of our corporate headquarters in Pittsburgh.

Cash on hand increased to 538 million after buying back 60 million of common stock, repurchasing 60 million of our 2024 bonds and funding the quarterly dividend. The average diluted share count improved to a Q2 exit rate of 421 million shares.

Net pension and OPEB liabilities were reduced by approximately $60 million in the first half of 2022, and cash contributions were reduced by approximately 65% to 13 million on a year-over-year basis.

Discount rates continue to be favorable, and we will remeasure at the end of the year, which should further reduce the net pension liabilities. Annual cash contributions are estimated to be approximately 60 million versus expense of 20 million. Finally, net debt to EBITDA improved to three times. As John mentioned earlier, we expect net debt to EBITDA to accelerate by year-end and move towards 2.5 times.

Moving to capital allocation. We continue to be balanced in our approach. Capital expenditures continued to be less than depreciation at approximately 67% in the second quarter. Productivity CapEx continues to be a focus on automation in both the engines and the fasteners business to improve yields, enhance quality, reduce outsourcing and mitigate labor risk.

We purchased approximately 1.8 million shares of common stock in the quarter for 60 million. In the first half of 2022, we repurchased approximately 6.9 million shares of common stock for 235 million.

I would also note that we purchased 0.9 million shares of common stock in July, which increases the July year-to-date repurchases to $265 million for 7.8 million shares with an average acquisition price of $33.76 per share. Board authorization for share repurchases is currently $1,082,000,000.

Moving to debt. We repurchased 60 million of our 2024 bonds in the quarter with cash on hand, and this will reduce our annualized interest cost by approximately 3 million. Lastly, we continue to be confident in free cash flow and paid a quarterly dividend of $0.02 per share of common stock.

Now let's move to Slide 7 to cover the segments. Q2 was another solid quarter for the Engine Products segment. Year-over-year revenue was 20% higher in the second quarter, with commercial aerospace up 39%, driven by the narrow-body recovery. Both IGT and defense aerospace were essentially flat year-over-year while oil and gas was up 24%.

Adjusted EBITDA increased 38% year-over-year and margin improved 360 basis points to a record 27.5%, despite adding approximately 455 employees in the second quarter. Year-to-date, net headcount additions for Engines was approximately 780 employees.

Please move to Slide 8. Fastening System's year-over-year revenue was 6% higher in the second quarter. Commercial aerospace was 20% higher, driven by the narrow-body recovery but somewhat offset by continued production declines for the Boeing 787. Industrial was down 26%, driven by a strong Q2 last year.

We expect growth in industrial in the second half. Segment adjusted EBITDA decreased 11% in the quarter and was impacted by inflationary cost and the addition of approximately 245 employees to support future growth. Year-to-date, headcount additions for Fasteners was approximately 380 employees.

Now let's move to Slide 9. Engineered Structures' year-over-year revenue was 16% higher in the second quarter. Commercial aerospace was 37% higher as the narrow-body recovery more than offset the impact of production declines for the Boeing 787.

Segment adjusted EBITDA increased 8% year-over-year despite the inventory burn-down of the F-35 and continued zero to low builds on the Boeing 787 and inflationary cost pressures. The Structures team delivered a Q2 EBITDA margin of 14.1%.

I would note that the Q2 adjusted EBITDA margin was equal to the 2019 annual margin despite revenue being down approximately 40% using this quarter's annualized revenue. This was solid performance by the Structures team.

Finally, let's move to Slide 10. As expected, Forged Wheels' year-over-year revenue was 22% higher in the second quarter. The $50 million increase in revenue year-over-year was driven by higher aluminum prices of 36 million and volume increases of 14 million or 7%.

Commercial transportation demand remains strong but volumes continue to be impacted by customer supply chain issues, limiting commercial truck production. Segment adjusted EBITDA increased 7% despite the impact of unfavorable foreign currency, driven primarily by the Europe. While the pass-through of higher aluminum prices did not impact adjusted EBITDA dollars, it did unfavorably impact EBITDA margins by approximately 400 basis points.

Before I turn it back to John to discuss guidance, you will note that we called out unfavorable foreign currency in the Wheels segment as a good portion of that segment's revenue has production cost and revenue in local currency.

For Howmet in total, the aerospace segments provide a natural foreign currency hedge, while the aerospace segments also have a portion of their production costs in local currency, the majority of the revenue is in U.S. dollars. For the quarter, Howmet's overall foreign currency earnings impact was less than $1 million.

Now let me turn it back over to John.

**John Plant**

Thanks, Ken, and let's move to the outlook. But first, let me provide some commentary about state of end markets and the customers that we serve. The narrow-body aircraft production increases will continue and we expect Airbus to continue to lead with second half A320 production rates in the mid-50s per month.

Boeing should lift the 737 MAX production to approximately 30 a month in the second half. Wide-body aircraft production is viewed as stable in the second half, and we are beginning to see spares demand increase due to improvements in international travel.

Our view is that the build of wide-body aircraft improves as we move through into 2023, especially with the production of the Boeing 787 restarting and combine that with the increases at Airbus of the A330 and A350.

The forecast for 787 production in 2022 is cut again from 25 aircraft I talked about in the last quarter's earnings call to 15 as our best estimate, although we are now optimistic about the future, given the clearance by the FAA to restart deliveries.

During the second half, we expect the F-35 inventory burn-off to continue, albeit defense revenue should show a modest improvement compared to the first half of the year. IGT is expected to improve, and we are seeing improvements which have signaled in the oil and gas market for the second half.

Commercial trucks production is expected to improve as supply chains improve component availability, albeit at a more muted level than we had previously expected. Regarding titanium orders, we expect to execute revenue opportunities as a result of the Ukraine situation, and we have added $20 million of revenue to our fourth quarter sales.

Further updates for 2023 and beyond should become more clear and secure during the next quarter or so as we not only assess the order intake but also customer inventory burn-down, especially for wide-body aircraft production.

Moving to guidance. The 2022 annual revenue midpoint is increased to $5.68 billion, which reflects the volume recovery commentary noted above and material inflation, which is now expected to be in excess of $200 million.

Other inflationary costs such as energy, electricity, transportation, services and other production parts are additive to this number. For the third quarter, revenue is expected to be 1.44 billion, plus or minus 15 million; EBITDA, 326 million, plus 5 million, minus 4 million; EBITDA margin, 22.6%, plus or minus 10 basis points; and earnings per share, $0.36, plus or minus $0.01.

For the year, we have also tightened our guidance range and called out revenue at 5.68 billion, plus or minus 35 million, which is an increase of 40 million from the prior midpoint guidance. EBITDA at 1.29 million, plus 9 million, minus 14 million.

EBITDA margin of 22.7%; and earnings per share of $1.41, plus or minus $0.02, an increase of $0.02 from prior guidance at the midpoint; and free cash flow, 650 million, plus or minus 25 million, an increase of 25 million from prior guidance. Free cash flow conversion of net income is expected to be approximately 110%.

In summary, Howmet's Q2 year-over-year and sequential profit improvement continues. And we have demonstrated Howmet's unique and differentiated assets. We have been making strong and consistent progress against a choppy backlog.

Liquidity continues to be strong with Q2 free cash flow at 114 million, including an inventory build in excess of 100 million for the commercial aerospace recovery. In the first half, total inventory build is close to 200 million.

Cash on hand has increased to 538 million and that is after the common stock and bond repurchases. Through the first half and July, approximately $343 million has been deployed for common stock and bond repurchases as well as dividends. Capital allocation has been balanced and we have also been improving net leverage as we spoke about and plan to do so again by the end of the year.

Regarding guidance, revenue for the year is raised, reflected the inflation recovery but also modest net volume improvements. EBITDA margin continues to be healthy and reflects the benefits of strong cost control, efficiency, material pass-through, inflation recovery and pricing with timely headcount additions to prepare for the future and the future lift into 2023. In the second half, we expect to continue to add headcount in Engines and begin recruitment in our Structures business.

Finally, the Howmet annual dividend of $0.08 per share or $0.02 per quarter is planned to be doubled to $0.04 per share per quarter, with the first higher payment made in

November of this year. Before moving to your questions, I would like to encourage you to visit our website at howmet.com to look at the Howmet's Technology Day slides.

As a brief introduction, I would like to highlight three slides beginning with Slide 14. What I want to note is that Howmet is a trusted brand with differentiated technologies and a rich IP portfolio with deep process know-how.

We are mission-critical in growing markets with the ability to supply 90% of structural and rotating aero engine parts - sorry, componentry. Approximately 70% of aerospace revenue is under long-term contracts, which is complemented by strong spares demand.

On Slide 15, 85% of revenue is generated from markets where we hold either a number one or number two position, driven by our customer relationships and differentiated assets.

Lastly on Slide 16, Howmet's strategy has four pillars: to grow above market rates; the prioritization of differentiated products with discerning allocation of capital and resources; commercial and operational discipline and finally, a disciplined capital allocation strategy.

Additional information is available in the full presentation, which is on our website in the Investors section. And now we can move to questions.

**Question-and-Answer Session**

**Operator**

[Operator Instructions] Our first question comes from Kristine Liwag of Morgan Stanley. Please go ahead.

**Kristine Liwag**

John, maybe I could start with a question on production rates. I mean, Airbus deferred a step-up of the A320neo production rate to 65 per month to early 2024 versus their previous expectation of second half of 2023. We are seeing Boeing face challenges to maintain 31 per month for the MAX as well.

So in a period where OEM production lines are changing and your business is in the longer lead time side of the supply chain, how do you balance investing to meet production rate increases and not be an industry bottleneck versus preserving the cost structure and maintaining margins?

**John Plant**

Well, certainly, it is a tough balance at the moment. And so far, we have tried to invest in adding people and training to get ready for the production increases. And as you have seen from the last quarter, continued to do so in preparing for the second half.

But as I noted in my comments, the backlog is pretty choppy. We saw in May, the 737 production halted for maybe 10-days or so, then maybe 20 Airbuses cut from the second half, and now next year, maybe a delay in the ramp of the A320 to, as you say, 2024.

So we find ourselves constantly having to readdress the, I will say, the slope of the recovery, albeit you have seen we have been pretty consistent in how we have been able to deliver against that backlog and hope to do so in the future.

I still think it is important to consider the fundamental premise of where we are, which is we are in a period of recovery, particularly for commercial aerospace. And defense is solid and hopefully improving for us. And then we have seen the recent buoyancy in the oil and gas sector plus the anticipated recovery, although I did say it, more muted in commercial trucks.

So what we are continually doing is balancing between how we see the addition of, in particular, headcount. It is not really affecting our fundamental capital expenditure plans at this point, given we have capacity, latent capacity from previous investments. But we adjust and trying not to get too far ahead but trying to be in-line for our requirements to customers.

When I think about one of the fundamental questions in the sector, which is the availability of castings and forgings, which you didn't mention but implied in your question was that point. Again, if you think back to the investments we made in two new engine plants in the 2019 period, then that has largely solved or if not completely solved the issue, which was very significant and present in 2017, 2018 and 2019, which was the capacity available for airfoil castings.

And I think one thing we have heard and increasingly heard is that the focus is more on availability of structural castings rather than turbine airfoil castings. And so we have been able to step up to that.

At the same time, as I have tried to say on previous calls, we have tens of thousands of parts. Inevitably, we are tight on a few and that would apply to also a few structural casting parts. But nothing that we are aware of that is fundamentally holding engine production or delivery of engines to an airframe manufacturer.

So we are trying to balance, be ahead of it, again investing in people, equipment, training to be ready. But I recognize that we do keep readdressing that labor intake as we see our customers' plans do change and then the anticipated slope of recovery.

But importantly, we have broadened it out one stage further is that we are clear that 2023 is going to be another growth year for Howmet and we look forward to that. And I will give more, I will say, guide on that towards the end of the year, if not in the early next year. But essentially, what we are playing for is the angle of the increase, not the fundamental principle.

Hope that covers it, Kristine.

**Kristine Liwag**

Great. I will stick to one question. Thank you John.

**John Plant**

Thank you.

**Operator**

The next question comes from Noah Poponak of Goldman Sachs. Please go ahead.

**Noah Poponak**

Hi good morning everyone. It looks like the updated guidance for the year implies that the EBITDA margins would be relatively flat in the back half versus the first, and I think the business segment margin actually down a little, the way the corporate and D&A shake out. And that would be on higher revenue and I assume you are passing through cost while pricing, you keep. So maybe just if you could walk me through why that would be the case.

**John Plant**

Yes. I mean, I think the major influence on it has been the fact we have kicked up our assumptions regarding the inflationary costs. And we said, just for the metals element alone, if you remember, we started out at the beginning of the year and calling it somewhere, I think, in the region of 100 million to 150 million. And now we are saying, I just said on the remarks is that we see north of 200 million now, and so significant inflation element.

And then that is ignoring, of course, the inflationary elements of utilities, I mean, natural gas in Europe in particular, where I think all of us are familiar with the energy crisis in Europe and the pricing points that energy has reached.

And so there is a lot to play for in terms of recovery of that or offsetting it. And as you know, if we cover dollar-for-dollar, which is where we believe we are, is that, that has a dampening effect on margin. And the more we kick up those inflation assumptions, then you see that, Noah.

So fundamentally, I believe that if we were to adjust for that, you will see growth of margin year-on-year. But again, that is like saying let's change the assumptions, I choose not to. I think the important thing is we are holding our margin rate through quite extraordinary times of inflationary pressures and also the choppiness that I referred to in answering to Kristine's question. And really, I think that delivery of consistent margins is really important. And we, I will say, quietly are fairly pleased with it.

**Kenneth Giacobbe**

Yes. Noah, I would add to that as well. We did bring down the 787 guide as well. That is a very profitable program for us. Now we did replace with some titanium. That is sort of lower margin so you have got a bit of a mixed component there. But also, I just wanted to clarify as well. So we said for Q3 EBITDA, 326 million.

It is minus 6 million on the down to 320 million, up 5 million for the high side in Q3. That is all on Slide 11. And then the earnings per share, I just want to clarify, we have it on the slide there. $1.41 is the mid or down $0.03 on the low and up $0.01 on the high, but just want to clarify.

**Noah Poponak**

Ken, how much titanium did you add into the back end.

**John Plant**

We added 20 million to revenue for the fourth quarter. I chose not to provide a guide for 2023 at this point because we are still in the process of order acquisition. And also even acquisition and completion of contracts with customers, then the next part is to balance out the inventory against new titanium supplies as that is on stream.

So again, we are trying to get a more accurate picture of what inventory is held at customers as they bank security stocks from, say, VSMPO. And so we have got to assess that. And when we provide you with a 2023 number. And if I gave you one today, I wouldn't feel confident in doing so.

**Noah Poponak**

We really shouldn't extrapolate anything from that 20 million, it sounds like?

**John Plant**

No. I mean, the important thing is the fact that we are gaining orders. We are well in the game. And clearly, it will be more than that in 2023, but just want to get all of that sorted before we - and clearly, it is more of a discussion to for the end of the year, early next year.

**Noah Poponak**

Thank you.

**John Plant**

Thank you.

**Operator**

Our next question comes from Gautam Khanna of Cowen. Please go ahead.

**Gautam Khanna**

Yes. I have a multipart question, trying to stick with the one. But your comment on -.

**John Plant**

Those are tricky, those multipart ones, Gautam.

**Gautam Khanna**

Yes, I know. It is kind of unfair. But the question is on share gain broadly and the opportunity. So on the forging side, you guys don't seem to be a pinch point. Are you seeing emergent demand there? And did that benefit the quarter or just bookings, given lead times? And secondly, on the titanium share opportunity, the 20 million you referenced, is that just one OEM, is it across several and have you seen any change in urgency for Airbus and Safran to source, given that you sanction was taken off of the VSMPO?

**John Plant**

Okay. So let me get the latter part first while it is fresh in my mind. It is several OEMs, both engine manufacturers and also an airframe manufacturer. So even though, let's say, European sanctions are not placed upon VSMPO. There, not surprisingly, Airbus choosing to secure a long-term source and security and so we have begun to book orders with them.

We are still working elsewhere with other manufacturers, and so still a lot to play for. And it is also, I'm going to call it, urgency of completion is also influenced by the inventories in the system. So I think that disposes of the titanium commentary.

In terms of spot, I did say the spot would be a feature - more of a feature in the second half. It is always difficult to call it by the fact it is spot, not on LTA. We are seeing some spot business that is available and coming to us and we have and secured some of it.

And some of it is already going in because of long lead times, particularly of metal availability into 2023 as metal lead times go out. And I see those going out nine-months, 12-months. And therefore, for some input orders, it is getting towards 12-months already.

In terms of, say, the pinch point in the industry, there is very little that can be done in the short term because, for example, on structural castings, it is all about the tooling and the assets that go with it.

And so really, there is limited ability to cross over on those sort of areas. And we have got our hands full just dealing with the orders that we have currently for ourselves. At the same time, I do believe that over the next two or three years, that there will be opportunities to further balance that supply. I think that covers all the points you raised, I think, Gautam.

**Gautam Khanna**

Yes, I appreciate it. Thanks.

**John Plant**

Thank you.

**Operator**

Our next question comes from Robert Stallard of Vertical Research Partners. Please go ahead.

**Robert Stallard**

Thanks so much and good afternoon. John, on the metal pass-through, we started to see some of these industrial metal prices come down. How does that flow through to you in terms of timing? And is the mathematical calculation basically the other way around, so you should have a margin expansion as the metal pass-through reduces?

**John Plant**

We would certainly like that to occur. I mean, you have seen some small improvements in metals and the most notable of which has been aluminum. So as that price has come down, say, peaked at about $4,500 a ton, including Midwest premiums in the U.S. and has probably fallen closer to, let's say, 3,100, 3,150 at the moment. So a significant move down, albeit still significantly above where it started at less than $2,000 a ton 18-months ago.

Assuming it stays there and of course, none of us know exactly what is going to happen, but if it stays there, then certainly, when our price resets occur on the first of January, then if it stays where it is, then you will see, for example, our Wheels business gain margin expansion as those prices are reset.

And if it comes down across the board elsewhere, where again, it is fairly small at this point, then there would be some other tailwinds to margin as well. But we haven't really called those out on the way up.

And so I doubt I will call them on the way down. The most significant has been the aluminum move which is impacted, as Ken talked about, in our Wheels business by over 400 basis points from where we started.

And clearly, to go down the other side of that would be very welcome. And so that would impact Howmet overall and you begin to see margin benefit if metals stay where they are or continue to further improve, which we obviously we are hoping for but we don't know if it is a future event.

**Robert Stallard**

Yes it makes sense. Thanks John.

**John Plant**

Thank you.

**Operator**

The next question comes from David Strauss of Barclays. Please go ahead.

**David Strauss**

So just want to get an update on the Wheels business, how the inventory situation looks there in terms of the semiconductors and the inventory or the backlog starting to deliver out. And how do you feel about the Class 8 truck business overall if we are headed into a macro slowdown recession, whatever you want to call it? Obviously, what we have seen in the past is that despite big backlogs on the Class 8 truck side that business can shrink pretty dramatically. Thanks.

**John Plant**

Yes. I don't think we have been in normal times for Class 8 truck in either the U.S. or Europe and have certainly the last 18-months.

And therefore, I'm going to say and I think I would like to believe that this time, it is different. So we don't see the same cyclicality and, of course, that might ring hollow because we don't know.

But my view is that the availability of trucks has been so restricted for so long and there is fundamental demand for fleets. And despite low order intake because people have just given up putting orders into the system.

But when those order books open for 2023 in September, that we are going to see a significant spike in orders from the larger fleets, where demand is clearly there because of the aging of the fleet and also to improve fuel efficiency with, say, regulations, which are particularly onerous in Europe.

So my thought is that the supply chain problems, while they are easing, so a lot of the trucks that have been built called red tags with not a complete part set, have been clear to some degree, there are still significant shortages across a range of commodities, which are restricting build in the second half of this year.

We have trimmed -- inside our guidance, we have trimmed our assumption by 5,000 or 10,000 trucks in North America as an example for this year because of a more conservative assumption regarding parts availability.

It does mean, I think, that we will see the same sort of percentage increase I talked about before between 2022 and 2023. And given the fact that I don't -- even if we are going to build more next year, or is going to build more next year and will supply more wheels, there won't be the opportunity, again because of parts availability, to draw forward truck build out of 2024 when people try -- have historically try to build and buy ahead of the emissions changes that are coming.

So my thought is that those emission changes will occur in 2024. Trucks will be built in the relevant calendar year and maybe even that people are interested in taking the improved fuel emissions from the trucks anyway.

So I'm hoping that what we are going to see is an improvement in overall revenues in our Wheels business in 2023 and stability and maybe even improvement into 2024 as well. And that is despite the coming macroeconomic backlog of rising interest rates to fundamentally deplete supply and demand -- the supply situation that we have had, which has been extreme.

So it is a long way of saying, I feel inherently optimistic about it, albeit I have calmed down the -- a little bit of the assumptions in 2022.

**David Strauss**

Alright. Thanks very much.

**John Plant**

Thank you.

**Operator**

Our next question comes from Matt Akers of Wells Fargo. Please go ahead.

**Matthew Akers**

Hi good morning and thanks. I wanted to ask about F-35 and kind of the defense business more broadly. And I guess, with sort of the lower outlook from Lockheed, just kind of where you are on F-35 stock, destocking. And I guess any other big moving pieces within the defense business. I think you talked about second half improvement over the first half. Yes, just any thoughts there.

**John Plant**

Yes. So for us, defense is a little bit seasonal, given the relatively large aftermarket component within it. And that is why it gives some confidence to second half solidity. At the same time, talking about the F-35 as a single item, which is about 35%, 40% of our defense sales, then we have been incurring the - I will say, destocking by our customer in the first half and that will continue in the second half. So the whole of this year, we are clear that we are under-supplying Lockheed's build of aircraft.

And we do note they have cut that build assumption from 156 down to, I would say, 147, 149 or something as an assumption for this year and next. And therefore, again, it places a little bit more of a burden upon us for inventory takeout, which again, may fall over into the early part of next year. But the fundamental picture is one where our supply situation in 2023, we expect, will be better and improved compared to 2022.

And again, what we are playing for is the angle of recovery just as I would commented about commercial aerospace earlier. So again, I just want to keep that big picture in mind the revenue increases and we are just debating the angle at this point in time.

**Matthew Akers**

Got it, thank you.

**John Plant**

Thank you Matt.

**Operator**

And our next question comes from George Shapiro of Shapiro Research. Please go ahead.

**George Shapiro**

John, of the $200 million for material pass-through, can you tell us how much of that goes to the Wheels business? And then just for this quarter, of the 40 million increase in revenues, how much of that was from the increase in the material cost?

**John Plant**

I'm going to say sequentially, this quarter was fairly minimal as a quarter-on-quarter, but I'm going to look to Ken in a second to cover that. I don't think we have broken down the 200 million between segment. But it is sufficient to say that the majority of that 200 million relates to aluminum.

And I'm going to look to Ken to see whether he has that level of detail, George, to be able to respond to you. So if you could just hold for a second.

**Kenneth Giacobbe**

Yes. So sequentially, it is really not a material impact, George. We haven't given - that 200 million, to your question, the breakdown of aluminum. But as you can imagine, aluminum is a big chunk of it. When you look at what we have talked about. So far in this quarter, we said 60 million of material pass-through of that. We had about 36 million, I believe I called out in my prepared comments, was aluminum. So I can kind of give you a guide.

**George Shapiro**

Okay. And then just one quick one, Ken. Can you break out the aerospace increase by how much was OE and look at it, how much was aftermarket?

**John Plant**

I'm going to say aftermarket, we generally don't call the numbers out, but aftermarket was a small improvement in the first half. We are expecting a bigger improvement in the second half. But you can assume the first half was within a single-digit percentage of what we were supplying in the second half of last year, George. But expecting bigger things to achieve, what we believe will be a 30% plus year-on-year improvement in the spares business for us.

**George Shapiro**

Okay. Thanks very much.

**John Plant**

Thank you.

**Operator**

And our next question comes from Seth Seifman of JPMorgan. Please go ahead.

**Seth Seifman**

Good morning everyone. Just looking at the Fasteners business, we saw the revenues kind of bottom out in the second half of 2021 and start to inflect higher here in the first half. But there is been some pressure on the EBITDA, I guess, from the second half of last year to the first half of this year. Some of these additional inflationary pressures outside of materials showing up more in the Fasteners or does it have to do with bringing on people now that revenue is growing again and how do we think about the incrementals here going forward?

**John Plant**

Yes. The inflation and certainly, materials inflation is not the biggest part of it. It is present, of course, across, let's say, titanium and some steel and aluminum for sure, but it is not the biggest part of it.

When I stand back and say, is our Fasteners segment underperforming? So it is always a good question to ask yourself. I don't believe so. There are two significant factors which are going on, which go to that margin.

One is the reduced build of composite aircraft and so if you look in the sequential margins of the business when 787 was basically taken down to, I will say, one to zero, then I think as we have explained before, the effect of a composite aircraft replacing a metallic aircraft is of significant value accretion for us. And therefore, we always look forward to that. And that is why we were looking forward to the 777X and the composite wings there, albeit obviously, that is pushed a little bit now.

But essentially, if you think about mix because of 787, which hopefully, certainly as we turn the year because even though, let's say, I think Boeing will begin to deliver from inventory, and I think they may begin to build at a little bit higher rate in the second half, I don't know. But a lot of that build is going to come from inventory.

And there are multiple tiers because of the distributed, I will say, supply base around the world of many of the components and trying to get an accurate picture of all that inventory is difficult. So that is why we have taken the assumption of 787 down to the 15 for the year from the 25. And therefore, that mix effect will continue to weigh on our Fastener business in the second half.

And then the second thing is we have taken on a significant amount of people in our Fastener business during the last quarter, preparing for volume improvements as we go forward. And we did see volume pick up in Q2, and we are planning for further volume increases in Q3 and Q4, which basically is embedded in our guidance because we have also, as you see, lifted revenue guidance, the rate of client continues.

So when you look at it, you shouldn't look at it compared to whether we beat consensus or beat guide or not, but you need to look at a more consistent track through the last year of consistent quarter-on-quarter, like we put on 100 million in like Q3 of last year, then a slight pause and another 100 million in Q1. Then we have just guided you to like another 100 million sort of average improvement.

So it is coming and we are recruiting. And so when you combine both the recruitment costs that we have incurred in Fasteners in Q2, plus that mix effect, that really goes to the heart of the margin issues or not an issue, but the margin change.

And then clearly, as those employees become more productive, and it is also going to be influenced by a rate of continued hiring as we prepare for next year, but I'm hoping that begins to improve because of the denominator will get bigger of the employee base. And then as 787 begins to start getting built in the first part of next year, then I do see things beginning to improve for that segment.

**Seth Seifman**

Great. Thank you very much.

**Operator**

[Operator Instructions] Our next question comes from Phil Gibbs of KeyBanc Capital Markets. Please go ahead.

**Philip Gibbs**

Within the guidance, are there any more buybacks implied in that, meaning from what you have already announced through July?

**John Plant**

What I would do is to guide you to what we have said by way of approaching 2.5 times net leverage by the end of the year. So you can reverse-engineer it from the cash flow that we have given you and an assumption around any balanced capital allocation between other than maybe reverse or the dividend increase, which I wanted to note, and that shows confidence in our cash flows and I think it is an important thing to do for our shareholders.

At the same time, we will also be addressing hopefully some improvement in our debt structure and also hopefully, some continued, say, buyback of stock. But you mustn't assume it is all of one or anything.

It is a balanced approach in that second half and you can get it is the -- whatever assumption you make in terms of whatever approaching 2.5 times is, so clearly better than three times. And I'm hopeful that, that will also reflect into the credit ratings of the company and also an approach which the - I will say, our shareholders are also pleased with that as well.

**Philip Gibbs**

Thanks John. You guys have gotten to be a public company now for several quarters. We are clearly on the other side of the demand cycle here for your key markets. The balance sheet looks like it is in good shape. Is there any thoughts to doing M&A? Are there opportunities out there available and the things that you would like to do strategically?

**John Plant**

Just picking up on your theme is that post separation, we went into the, I will say, COVID pandemic, but within times quarters, we would restored our margins. We have been consistent in performance and cash flow all the way since then. And as you have seen, putting the balance sheet in really great shape approaching eventually probably more of our target leverage, around that two times or better.

So everything is progressing very satisfactorily. We are open to considering any M&A moves. But I always say it is more in that bolt-on scale, which we can deal within a quarter or so of cash flow and so no immediate thoughts to doing that. It is got a high hurdle to overcome, which is, does it provide a good return on capital for any such investment.

Can we gain not only cost synergy but revenue synergy? And therefore, does it go with the strategic intent of the company? We have aimed it more, if we said if we are going to do it, it is probably more likely in our Engine or our Fastener business rather than elsewhere.

But at the same time, again, trying to try and be disciplined about it all, but nothing that immediately would pass any hurdles compared to the relative risk-free I will say, action of buying our own stock back, which we obviously know well, feel confident in and have been consistent in buying back really almost every quarter over the last couple of years but only probably pause for a quarter or so in 2020 just after the, I will say, the onslaught of the pandemic.

**Philip Gibbs**

Solid. Thanks gentlemen.

**Operator**

And our next question comes from Michael Ciarmoli of Truist Securities. Please go ahead.

**Michael Ciarmoli**

Hey good afternoon guys. Thanks for taking the questions here. Just I guess John or Ken, how should we think about inventory into the second half of 2022 and maybe overall working capital as we really think about 2023? I mean, it seems like there is a number of moving parts with the F-35 burn going on. It sounds like and it seems like 787 is going to be ramping. Not sure if you need much or need to plan much for some of the titanium. And then I guess the truck's a little bit slower than you initially planned. Can you just give us any color on where inventories might go?

**John Plant**

Yes. I mean, I will deal with our own inventory first before I comment on anything to do with our customer inventories. And we built a couple of hundred million of inventory in the first half. And we have tried to aim the majority of that towards finished goods.

But not exclusively but a lot of it towards finished goods or certainly very advanced stage of work in progress, so that we can and have tried to keep pace and be able to satisfy our customers and have that ability to deliver our stock to meet their needs. And we are only tight in one or two places. Now having put that what I call the stock for hopefully improved supply security in the face of the lift in the demand is that I doubt we will try to replicate that again in the second half.

There may be some but nothing at the scale of the first half, and trying to plan a steady level of production throughput improvements from the hiring we have done as we exit this year into 2023. And obviously, we will make those judgments exactly how much inventory we will carry into next year according to what the final shape of the increase in revenues for next year is.

So I think all good on that front. So more of, it is less of a build and more of a pause but maybe some selective improvements in inventory in the second half. In terms of our customer inventory, it is difficult to really comment.

I said 787, despite meaning we could assume that there will be build of aircraft in the second half. And I have a feeling that maybe you may see a higher increase in build than we thought because it may prove to be a good way of supplying those 787s into clearly, the airline demand, which is there, compared to the inventory we have.

But we don't know that. And we have just said there is clearly inventory in the pipeline. There is inventory around, whether it is subsuppliers in Europe or in Japan or elsewhere in the world or in the U.S.

And so let's be relatively safe. And therefore, we chose to take down our view of 787 for the second half, given the fact that it has been delayed from last year to Q1 to Q2. But all seems to be set well now.

And as I have said in previous calls, the aircraft is a great aircraft. There is clearly demand and need for it there. International travel is coming back. And so I think that plus I have read that Airbus are considering even looking at possibly improving their wide-body rates as we go into next year beyond more than they have already signaled in Skyline.

So I have some optimism, but really choose to say the improvement particularly for wide-body will be more of a 2023 feature and also for our commercial truck business. So I think that puts it out, Mike.