Raytheon Technologies Corporation (NYSE:RTX) Q2 2022 Earnings Conference Call July 26, 2022 8:30 AM ET

Company Participants

Jennifer Reed - Vice President, Investor Relations
Greg Hayes - Chairman and Chief Executive Officer
Neil Mitchill - Chief Financial Officer

Conference Call Participants

Ron Epstein - Bank of America
Robert Stallard - Vertical Research Partners
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Noah Poponak - Goldman Sachs
Sheila Kahyaoglu - Jefferies
Peter Arment - Baird
Robert Spingarn - Melius Research
Seth Seifman - JPMorgan

Operator

Good day, ladies and gentlemen and welcome to the Raytheon Technologies Second Quarter 2022 Earnings Conference Call. My name is Latif and I will be your operator for today. As a reminder, this conference is being recorded for replay purposes. On the call today are Greg Hayes, Chairman and Chief Executive Officer; Neil Mitchill, Chief Financial Officer; and Jennifer Reed, Vice President of Investor Relations. This call is being carried live on the Internet and there is a presentation available for download from Raytheon Technologies' website at www.rtx.com.

Please note, except where otherwise noted, the company will speak to results from continuing operations, excluding acquisition accounting adjustments and net non-recurring and/or significant items often referred to by management as other significant items. The company also reminds listeners that the earnings and cash flow expectations and any other forward-looking statements provided in this call are subject to risks and uncertainties. Raytheon Technologies' SEC filings, including its Forms 8-K, 10-Q and 10-K, provide details on important factors that could cause actual results to differ materially from those anticipated in the forward-looking statements. [Operator Instructions]

With that, I will turn the call over to Mr. Hayes.

Greg Hayes

Thank you, Latif and good morning everyone. I hope everyone had a chance to see our press release this morning. From that press release, I think one of the key takeaways is we had a really strong quarter for commercial aerospace and we continue to see very strong demand for our products and services, as evidenced by our defense book-to-bill in the quarter of 1.35, incredible number. We delivered these results in the midst of, I would say, a challenging period across our industry and most of industrial America. Inflation, supply chain and labor availability continue to be near-term constraints. We are working these things relentlessly by leveraging our scale and our portfolio to combat all of these different pressures.

Before we get into the results, let me just spend a few minutes on the macro environment. On the defense side, the evolving threat environment, including the ongoing conflict in Ukraine, continues to drive global defense budgets higher. Most of our NATO allies have reaffirmed their commitment to spending at least 2% of GDP on national defense with many countries announcing even higher spending targets over the last several months. For example, Poland has requested accelerated delivery of Patriot missile systems batteries and both Germany and Finland have selected the F-35. As you know, the Department of Defense released its fiscal year '23 budget request earlier this year, with modernization spending growing over 4% and with modernization accounts, specifically RDT&E, expected to grow by nearly 10%.

We are also encouraged by the markets that we've seen in Congress. The House Arm Services Committee has proposed a $37 billion increase to the administration's request, that's a 9% increase over fiscal '22, excluding the supplementals. On the Senate side, the Senate Arm Services Committee went even higher proposing a $45 billion mark, resulting in a DoD budget increase of 10% over fiscal '22, bringing the fiscal year '23 budget to over $815 billion. It's a lot different than what we expected 2 years ago.

We are encouraged by the support of our programs with the authorizing committees recommending significant increases in spend over the President's budget request, including increases for Stingers, Javelins, next-generation jammers, Tomahawk cruise missiles, just to name a few. And as I have said, our key programs in technologies and space cyber, missiles, missile defense and non-kinetic effects are also well aligned with the U.S. and our allies' defense priorities. We ended the quarter with a defense backlog of $65 billion, that's up about $2 billion since the beginning of the year, and we expect it to grow even further in the remainder of the year.

In the second quarter, we also saw a number of significant awards, including $4 billion to deliver F135 engines for lots 15 and 16, which will power all variants of the F-35 fighter. The total contract value opportunity is about $8 billion for F135 engines across lots 15 through 17. In addition, we received a $408 million contract for sustainment of the F-35 fleet – F135 fleet rather. The F135 engine continues to be the most advanced, and I would say, safest fighter engine ever produced and possesses unrivaled operational capability and mission effectiveness. As the global threats evolve, the F135 can be upgraded to increase its thrust, range and power thermal management to support the needs of the war fighter well into the next decade. We also received a $648 million award to deliver SM-3 missiles to the Missile Defense Agency, a $662 million awarded R&D to replenish 1,300 Stinger missiles as well as awards to replenish Javelin missiles. RIS also had a $1.2 billion bookings of classified programs.

During the quarter, RMD was also down selected by the MDA to continue developing our first-of-its-kind counter hypersonic missile, the Glide Phase Interceptor. In a few weeks – just a few weeks ago, RMD along with our industry partner, Northrop Grumman, successfully completed the second flight test of the scramjet-powered Hypersonic Air-breathing Weapon Concept, or HAWC, for DARPA and the U.S. Air Force. The flight test applied the data and lessons learned from the first flight test last September to demonstrate how rapidly we have matured affordable scramjet technology.

At the same time, commercial air traffic demand continues to gain momentum with a strong start to the summer travel season. Globally, Q2 revenue passenger miles reached nearly 70% of the pre-pandemic levels. In the U.S., travelers through TSA checkpoints were up 30% year-over-year in the second quarter or nearly 90% of 2019 levels. And with travel restrictions easing around the world, we expect growing demand for international travel in the second half of the year, with international revenue passenger miles growing from over 60% of 2019 levels at the end of Q2 to about 75% to 80% of 2019 levels by the end of the year. That being said, we all know that global supply chain isn’t where it needs to be and we are aggressively managing these issues everyday. Microelectronics, rocket motors, structural castings, all continue to pace manufacturing lines. Today, we have people embedded about 330 of our suppliers to help improve performance. And we are also qualifying second, in some cases, third sources for critical parts as necessary.

Inflation also continues to be at elevated levels, no surprise there. However, on the commercial side, we have long-term agreements in place that cover about 80% of our spend and cover multiple years, which provides an inflation buffer at least in the near-term. On the defense side, we can price inflation into annual production contracts and flow through our rate structure. Additionally, we are driving further automation, standardization and process improvement projects throughout the company to mitigate inflation headwinds.

And lastly, and perhaps just most importantly, the availability of skilled labor is a real challenge across multiple industries right now and we are seeing it both at our suppliers and within our own shops. It takes time to hire and train new employees. It doesn't just happen overnight, especially in certain areas such as much of our classified work. Despite these near-term challenges, what differentiates us is our balanced A&D portfolio and our world class technologies that gives us the ability to deliver on our commitments.

Okay. I was going to just take a quick look at Q2. And I am on Slide 2, for those of you following along. We delivered another solid quarter, with sales growing 4% organically. Adjusted EPS was a little bit ahead of our expectations at $1.16 and that's up 13% versus the prior year and free cash flow was essentially in line with our expectations. Growth in the quarter was led by strong commercial aftermarket sales that were up over 26% from the prior year. This strength was partially offset by continued supply chain and labor constraints that principally impacted the defense businesses as well as some delays in expected contract awards. Notwithstanding these challenges, we continue to see full year sales in the range of $67.75 billion to $68.75 billion. And adjusted EPS, we continue to see that in the $4.60 to $4.80 range. However, there are some changes within the segments as strength in the commercial aero will help to offset impacts in our defense businesses that Neil and Jennifer will discuss in just a little bit later in the call.

As far as our cash flow outlook, we continue to expect about $6 billion of free cash flow for the year. That's of course assuming that the R&D tax legislation is repealed. Finally, we repurchased over $1 billion of RTX shares in the quarter, putting us at about $1.8 billion year-to-date and we remain on track to repurchase at least $2.5 billion for the year. Through the end of the second quarter, we have already returned nearly $11 billion of capital to shareowners since the merger in April of 2020 and we are more than halfway to our commitment to return at least $20 billion in the first 4 years following the merger.

With that, let me turn it over to Neil and I'll be back at the end for a wrap up and Q&A. Neil?

Neil Mitchill

Thank you, Greg. Before I talk about the full year, let's look at the second quarter results on Slide 3. As Greg noted, sales of $16.3 billion grew 4% on an organic basis versus the prior year. Our performance in the quarter was driven by the continued recovery of air travel due to the pent-up demand that was partially offset by continued supply chain constraints that, as Greg said, principally impacted our defense businesses. Adjusted earnings per share of $1.16 was up 13% year-over-year and with ahead of our expectations primarily driven by strength in commercial aftermarket at Collins and Pratt and some favorable corporate items, including lower tax expense, which more than offset the impact of lower defense volume and productivity. On a GAAP basis, earnings per share from continuing operations was $0.88 per share and included $0.28 of acquisition accounting adjustments and net significant and/or non-recurring items. And finally, free cash flow of $807 million was generally in line with our expectations for the quarter.

So, let me give you some perspective on how we are thinking about the environment as we look ahead to the second half of the year. Let's turn to Slide 4. I will start with some positives. The recovery in commercial air traffic remains as strong – very strong as airlines entered the summer travel season with leisure travel bookings well above 2019 levels and the active fleet is at its highest level since the beginning of the pandemic. And as you saw our commercial aftermarket sales continue to grow generally in line with our expectations for the quarter. Geographically, U.S. domestic demand has remained strong, while China domestic travel has lagged our expectations so far this year. That said, domestic air traffic in China began to rebound as lockdowns ease throughout the second quarter.

On the international front, short-haul international travel or intra-region travel has been quite strong, fueled by a stronger-than-expected European recovery so far this year. And long-haul international travel or trans-regional travel has shown slow, but steady sequential growth. And while this is encouraging, we need to see this segment of the market accelerate in the second half of the year.

On the defense side, as Greg mentioned, we are optimistic about the fiscal '23 budget request and our continued alignment with the priorities of the United States and our allies. And on the cost reduction front, we remain laser-focused on driving operational excellence and our structural cost reduction projects to deliver further margin expansion. In the second quarter, we achieved about $80 million of incremental cost synergies, keeping us on track to achieve $335 million this year and well on our way to $1.5 billion of total gross cost synergies since the merger. At the same time, we continue to monitor the broader geopolitical landscape as well as the U.S. and global tax environment.

And finally, on the challenges side, we continue to see global supply chain and inflationary pressure as well as labor availability constraints. During the second quarter, we saw slower-than-expected recovery in material receipts and the resulting impacts to our shop productivity along with increasing inflationary pressures in labor, freight and other indirect cost areas. And while we remain focused on aggressive mitigation actions, we don't expect these pressures to ease until next year.

So moving on to our outlook on Slide 5, we continue to expect our full year sales to be in the range of $67.75 billion to $68.75 billion. However, due to continued supply chain and labor constraints, we now expect lower sales and operating profit at both RIS and RMD for the full year. Those sales impacts are expected to be largely offset by the stronger commercial aerospace recovery we are seeing at Collins and Pratt. From an earnings perspective, we are holding our adjusted EPS range of $4.60 to $4.80 per share, but expect to be more towards the midpoint of the range as we don't expect some of the headwinds to fully recover in the year. I should also point out that we continue to work mitigations to offset the impact of ceasing business activities with Russia and minimizing any impact to our customers.

I will provide more color on the moving pieces between the businesses in a moment. And on the cash front, we continue to expect free cash flow of about $6 billion for the year. It's important to mention that our cash flow outlook continues to assume that the legislation requiring R&D capitalization for tax purposes is deferred beyond 2022, which, as I have said before, the free cash flow impact of this legislation is approximately $2 billion for the year. If the legislation isn't deferred by September 15, we will have to make an incremental cash tax payment of about $1.5 billion here in the third quarter. However, this payment is a timing issue only as we will receive a refund in 2023 for the overpayment if the legislation is ultimately deferred by year end as we continue to expect.

So with that, let's move to Slide 6 for some color on the segment outlooks. At Collins, we continue to expect full year sales to be up low double-digits versus prior year, where we now see a little stronger commercial aftermarket recovery that's partially offset by supply chain-induced pressures on military sales. As a result of better sales mix and spending containment measures, we are increasing Collins adjusted operating profit from up $650 million to $800 million to a new range of up $700 million to $825 million versus last year.

Turning to Pratt & Whitney, we are increasing Pratt & Whitney sales range from up high single to low double-digits to a new range of up low-teens versus prior year and that's driven by stronger commercial aftermarket and better commercial OE mix. With respect to operating profit at Pratt, we are increasing Pratt's adjusted operating profit from a range of up $500 million to $600 million to a new range of up $550 million to $650 million versus last year.

Turning to RIS, due to the pressures we have discussed along with delays in awards, we are reducing RIS' reported sales outlook from down slightly to a new range of down mid single-digit to down low single-digit versus prior year. And organically, we are reducing RIS' outlook from up low single-digit and now see RIS' organic sales roughly flat versus prior year. And as a result of lower sales outlook and the impact of unfavorable development program adjustments, we are reducing RIS' full year adjusted operating profit from the prior range of flat to up $50 million to a new range of down $50 million to flat versus prior year.

And finally, at RMD, also due to ongoing material availability delays and the associated productivity impact, along with the anticipated cost reduction, we are reducing RMD's full year sales outlook from the prior range of up low to mid single-digit to a new outlook of up slightly versus prior year. And as a result, we are reducing RMD's adjusted operating profit from a prior range of up $150 million to $200 million and now expect RMD's operating profit to be in the range of down $50 million to flat versus prior year. And we also expect some improvement in some corporate spending and a lower full year tax rate. We have included and updated out some of those below-the-line items in the webcast appendix.

So with that, let me hand it over to Jennifer to take you through the second quarter segment results.

Jennifer Reed

Thanks, Neil. Starting with Collins Aerospace on Slide 7, sales were $5 billion in the quarter, up 10% on an adjusted basis and up 11% on an organic basis driven primarily by the continued recovery in commercial aerospace end markets. By channel, commercial aftermarket sales were up 25% driven by a 33% increase in parts and repair, a 20% increase in provisioning and an 8% increase in modification and upgrades. Sequentially, commercial aftermarket sales were up 3%. Commercial OE sales were up 14% versus prior year with strength in narrow-body offsetting expected headwinds from lower 787 deliveries.

Military sales were down 6% driven primarily by lower material receipts on military programs and expected declines in F-35 volume. Adjusted operating profit of $617 million was up $99 million from the prior year. Drop-through on higher commercial aftermarket more than offset higher SG&A expense, the absence of favorable contract settlements and lower military sales volume. Looking ahead, as Neil discussed, we continue to see Collins' full year sales up low double-digits and we now see adjusted operating profit up $700 million to $825 million versus last year.

Shifting to Pratt & Whitney on Slide 8, sales of $5 billion were up 16% on an adjusted basis and up 17% on an organic basis, with sales growing across all segments. Commercial aftermarket sales were up 26% in the quarter, with growth in both legacy large commercial engine and Pratt Canada shop visits. Commercial OE sales were up

22% driven by higher GTF deliveries and favorable mix within Pratt's large commercial engine business.

In the military business, sales were up 5% driven primarily by the timing of F135 production contract award in Q2, higher F135 aftermarket volume. Adjusted operating profit of $303 million was up $207 million from the prior year. Drop-through on higher commercial aftermarket, favorable commercial OE mix along with higher military volume were partially offset by higher SG&A and R&D. Looking ahead, we now expect Pratt sales to be up low teens and for adjusted operating profit to be up $550 million to $650 million versus 2021.

Turning now to Slide 9, RIS sales of $3.6 billion were down 6% versus prior year on an adjusted basis primarily driven by the divestiture of the global training and services business. Sales were down 1% versus prior year on an organic basis due to lower expected sales in command, control and communications as well as lower sales within sensing and effects that were partially offset by higher sales in classified cyber programs within cyber training and services. The quarter was also impacted by the delay of certain contract awards.

Adjusted operating profit in the quarter of $315 million was down $100 million versus prior year primarily driven by lower net program efficiencies, including unfavorable development program adjustments, the impact of the divestiture in the absence of a land sale in the prior year. RIS had $3 billion of bookings in the quarter, resulting in a book-to-bill of 0.92 and a backlog of $16 billion. It's worth noting that we continue to expect RIS' full year book-to-bill to be greater than one.

Turning to RIS' full year outlook, as Neil discussed, we now expect RIS sales to be down mid-single digits to down low single digits on a reported basis versus prior year and to be about flat on an organic basis. And we expect RIS adjusted operating profit to be down $50 million to flat versus prior year.

Turning now to Slide 10, RMD sales were $3.6 billion down 11% on an adjusted basis and down 10% on an organic basis primarily driven by continuing delays in material availability and expected declines in certain land, warfare and an air defense program that were partially offset by higher volume on SPY-6 production and next-generation interceptor development. Adjusted operating profit of $348 million was $184 million lower than prior year driven primarily by lower net program efficiencies resulting from continued supply chain constraints and unfavorable program mix and lower volume primarily in land, warfare and air defense programs.

RMD's bookings in the quarter were approximately $4.5 billion, resulting in a book-to-bill of 1.3 and a backlog of $30 billion. In addition to the awards that Greg discussed, RMD also booked $423 million on the SPY-6 hardware production and sustainment program and $217 million for Tomahawk production for the U.S. Navy. For the full year, we now expect RMD's full year book-to-bill to be closer to 1.2. And looking ahead, we now expect RMD sales to be up slightly versus prior year and for adjusted operating profit to be down $50 million to flat versus prior year.

With that, I'll turn it back to Greg to wrap things up.

Greg Hayes

Okay. Thank you, Jennifer. I'm on Slide 11 now. We will be just a second for Q&A. So despite some of the macro uncertainties for the remainder of the year, we're well equipped to mitigate the challenges that we talked about: supply chain, inflation and labor availability. We're going to do that through our focus on cost reduction, operational excellence, all in order to meet the commitments that we set out to investors earlier this year.

And while we continue to make progress, let me just say that we're certainly not satisfied with the performance in our defense businesses this quarter. There is much to do. Bookings were outstanding; execution, not so much. At the same time, we continue to invest in technology and innovation for our customers as well as execute on our capital allocation strategy to drive significant long-term growth and shareholder value well into the future. With our industry-leading franchises across A&D, we're prepared to capitalize on the commercial aerospace recovery and growing defense budgets. Balance continues to work.

And I think most importantly, we remain confident in our ability to hit the 2025 targets that we set in May of last year at our investor meeting. There is a lot to do. There is always more to do.

With that, let's open up the call for questions. Latif?

Question-and-Answer Session

Operator

[Operator Instructions] First question comes from the line of Ron Epstein of Bank of America. Please go ahead, Ron Epstein.

Ron Epstein

Hi, good morning, Greg.

Greg Hayes

Good morning, Ron.

Ron Epstein

So maybe if we can peel back the onion more on what's going on in the supply chain and defense. And for RMD, right, you were down 7% in the first quarter, 11% this quarter. You say you're going to be up during the year, which means you're going to have a pretty good inflection. How is that going to happen? It's almost a little hard to believe. And then I guess, another way to ask this, it seems like your commercial businesses right now are run better than your defense businesses, but there are any lessons that the defense businesses can learn from the commercial business? Because it's really surprising, I mean you guys are a DX-designated company. So you should have full-on ahead of the line right in terms of supply chain. So what's really going on there? Because it's surprising that it's hitting you guys so hard.

Greg Hayes

Ron, that is the question of the day. I would tell you. First of all, just to be clear, most of our programs are not DX-rated. In fact, there are very few where we have DFAS ratings that give us priority on in the supply chain. Again, those are very, very few. But I'll tell you, there is a couple of significant differences between our commercial businesses and the defense side. On the commercial side, you probably say this for about 80% of our supplies suppliers around long-term agreements, right? That long-term agreement allows us the ability to give forecast demand, but it also gives us a priority. And our suppliers as part of those LTAs are required to keep buffer stock in place. Now, all that gives us certainty of cost and certainty of delivery. Now it doesn't always work. We talked about structural castings at Pratt & Whitney back in Q1. That continues to be a challenge. But for the most part, the commercial businesses have done a better job, I would say, because of the way we structure those long-term agreements. If you look at the defense side of the business, only about 10% of those businesses of RMD and RIS, suppliers are on long-term agreements. And that's not surprising because of government contracting rules.

The problem that we've had is as we've received all these new awards, we've been going out – and once the award is set once the contract is signed, we're going out and we're putting – or suppliers on contract, and we're seeing lead times double and sometimes triple. And we have been, I would say, caught off-guard a little bit by how much pressure there is in the supply chain. And I would tell you, it all goes back to labor availability. Typically, during these – the downturn that we saw in A&D 2 years ago, there was a lot of layoffs. There is a lot of people that were let go. Typically, we get about 75% to 80% of those folks come back off of layoff. In this case, what we're seeing in our supply chain is only about 25% of the people are coming back. They have found other jobs, similar jobs. Again, because the labor market is so tight in this country, we just don't have a large pool of resources.

The other problem I would tell you again, it's not just material. It's also labor availability. I'm thinking about our RIS business, which has over 5,000 programs that we're executing on, right? That requires engineers and engineers with clearances. If you look at the unemployment rate for engineering talent in the U.S., it's less than 2%. We started the year with a goal of hiring about 2,000 engineered net of attrition, which means we have to hire probably more than 5,000, and we are struggling in that regard as well. And again, you don't think about it, but engineers working on programs generate revenue. And so as we think about the issues in Q2 and really the first half of the year, we have seen the supply chain but also a labor availability impact our defense businesses. As you talk about the back half of the year, you're absolutely right, there is a lot of work to do. Right now, just to give you a couple of statistics, in the second quarter, in our factories, we typically look to provide kits to the shop floor to assemble, and we target somewhere between 90% and 95% kit availability. In other words, all the parts are there, 90% to 95% of the time.

In the second quarter, because of all of these supply chain constraints, we saw kit fill rates around 50%, 50%. So you can imagine the amount of rework, the lost productivity in our shops as we are starting things that are not complete. Going back, doing rework, all of that is what's causing some of these headaches on the defense side. Now as we look at the back half of the year, we've had some very deep dive reviews with Chris Calio and Neil Mitchill with the guys going out and making sure that we have line of sight to the supply recovery plans. And we expect kit fill rates, for instance, to go from roughly 50% to about 80% by the end of the year. That's a big get, but we absolutely have to do that. And again, we are deploying resources.

As I said in our comments, we've got about 30 suppliers where we have people today working through all this. It is pick-and-shovel work, and it's also about trying to make sure they have got the right labor – trained labor to get all this done. So it is a hill to climb in the back half of the year, and it is a challenge that we're going to have to take out in order to – first of all, to meet our customer demands or our customer needs. I mean this is really about making sure we can deliver to our customers on time. And right now, we're suffering. I don't know, Neil, anything you want to add to that?

Neil Mitchill

Maybe I'll just put a little color around the kind of hill that we're looking at for the second half. At RMD, one of the big challenges is the material receipts. We talked in the first quarter about sort of COVID-induced labor issues in the supply chain. We expected that to get better in the second quarter, and it did not. And in fact, it got a little bit worse. When I look at the second half of the year, RMD in particular, needs to see about a 25% volume step-up in dollars in the second half versus the first half. Obviously, our new outlook for RMD reflects that. And at RIS, material is also an important part of their products, and it's about a 15% step-up in the second half. So those are the metrics that we're monitoring on a daily and weekly basis. As it relates to their performance, the only other thing, Greg, I would add is productivity. So one of the big reasons, I'd say about half of the drop in the margin at RMD in the second quarter was related to lost productivity, the absence of productivity. And our profit outlook for the remainder of the year for RMD reflects us not catching up on that productivity given the kit fill rate issues that you talked about.

Ron Epstein

Great. Thanks. If I can, I mean, going from 50% to 80%, is that even a realistic goal? I mean given – I mean most of the points that you brought up about hiring people that fast turnaround stuff, right? I mean that's – it's not something that's going to change on the dime. If you're use...

Greg Hayes

Let's be clear, Ron, this does not get solved this year. I think, again, getting to a kit fill rate of 80% is interesting. But literally, we need to be at 95% to be running at I would say, a normal pace. It is a lot of work. We've done a lot of, I would say, deep dive reviews on supply chain, going through supplier by supplier. That's why we've got people out of all of these different suppliers, making sure they are meeting their commitments. I think the only thing that's going to solve labor availability, I hate to say this, is a slowdown in the economy because right now, there just simply aren't enough people in the workforce for all of our suppliers. And look, we pay a very, very competitive wage at RTX. But as you go down into the second, third and fourth tier of the supply chain, they are struggling to attract workers. But again, we've got people out there. I would tell you, as we've done these reviews, we have a path to get there. It is not an easy path. It is going to be a challenge throughout the year. And we will see how we do – we're tracking material receipts day by day, and it's a big hill.

Ron Epstein

Alright. Great, thank you, guys.

Greg Hayes

Thanks, Ron.

Neil Mitchill

Thank you.

Operator

Thank you. Our next question comes from the line of Robert Stallard of Vertical Research Partners. Please go ahead, Robert Stallard.

Robert Stallard

Thanks so much. Good morning.

Greg Hayes

Good morning, Rob.

Robert Stallard

Greg, maybe to follow-up on Ron's point there on supply chain and labor and the impact of inflation. What do you see as the – your ability to pass this on you? Is there a cap to how much you can pass this, up the chain or it's going to be different in aerospace versus defense? But is there a point where you have to start biting more of the bullet of these cost increases?

Greg Hayes

As we look at it this year, Rob, we've got about $200 million of additional inflation headwind that we didn't anticipate when we started the year. So that $200 million, we've had to go out. We've done a number of initiatives looking to ways within the supply chain to eliminate that headwind. And so far, we've done a pretty good job of that. Keep in mind, that's on top of about $300 million of headwind from the Russia exit that we had earlier in the year. So I would tell you, the team has done a good job in managing cost and finding ways to overcome some of the headwinds that we've seen. On the commercial side, again, the LTA coverage at 80% really provides you a lot of coverage with inflation. Now there is dead bands in there and excess inflation above some levels. Usually 6% or 7% gets shared with the supplier. But for the most part, we've been able to manage through that. On the defense side, what we've seen – again, we've seen labor inflation clearly. We've been able to put most of that, though, into our overhead rates, and that gets recovered in the normal contracting process. We've also seen, again, just inflation in the supply chain. But again, most – well, I would say, at least 30% of the work that we have is cost type at RMD. And so you're able to pass that along. And right now, again, I think one of the reasons we continue to push this on the RMD side is to make sure that we can overcome the inflationary impacts that we're seeing in the supply chain there. So I think, again, we need to learn the lessons of how we manage this from the commercial side. And going to more LTAs, I think, is absolutely essential if we're going to be able to have some kind of consistency in terms of supply chain going forward.

Robert Stallard

That's great. Thanks, Greg.

Greg Hayes

Thanks, Rob.

Operator

Thank you. Our next question comes from the line of David Strauss of Barclays. Your question please, David Strauss.

David Strauss

Thanks. Good morning.

Greg Hayes

Good morning, David.

David Strauss

Greg, could you maybe touch on the recovery on the GTF side of things? I think you had missed 70 in Q1. You were saying you were to about 180 – up around 100 deliveries for the full year. Can you just talk about where you are there? And then also talk on the Pratt Canada side. I saw deliveries were down in the quarter. I think you had highlighted previously that titanium was a pretty big issue on the Pratt Canada side? Thanks.

Greg Hayes

Yes. Thanks, David. Let me – just on the GTF side. I would tell you, right now, we continue to deliver GTS behind schedule. And we will not catch up, as I think I said back in February until the end of the year. And this is – again, goes back to a single issue around structural castings. We're not holding up the line at Airbus. That's the good news with the 1100. We're not holding up the line on the 1500s either on the C Series or I guess, the A220. So we're managing this with the customers. We're managing this with the supply chain. And we really expect – again, you're going to see a big step-up in the back half of the year on GTF deliveries. As you think about your Pratt had a great first half. Second half, again, even with the recovery in commercial aftermarket, it's going to be tough because you got a lot more negative engine margin in the back half of the year. So again, that all goes into the calculus of the full year guidance.

But I would tell you right now, there is no other surprises on GTF beyond those structural castings. And there is always little things, David, but nothing huge. On the Pratt Canada side, you're exactly right on titanium. And again, this is primarily around the sanctions and our inability to continue to buy nor our desire to buy anything from Russia. So we have been working to identify second sources, qualify them. I will tell you we will impact production lines at a number of our customers. I'm sure you're going to hear that from them as well on the biz jet side. We're just not going to be able to make all the deliveries.

Now we're not talking about dozens and dozens of aircraft, but you're talking 5 to 10 airplanes at these customers that are going to be without engines because we don't have the titanium forgings that we had expected to get this year. So again, this will recover sometime in the middle of next year, but there is still a lot of work to do to get these suppliers re-qualified. And I think every single person in commercial aerospace is facing the same problems with Russian titanium. The fact is it wasn't a huge piece of the supply chain, but it was 20% plus of global titanium and we are all going after those same resources. Interestingly, we were in the Farnborough last week. I had a good conversation with a number of our suppliers on this. People are stepping up. People understand this is a long-term business, and I think the suppliers of titanium see this as a big opportunity to take share. So, we will work through it, but it's not going to be without a little bit of pain to our customers.

David Strauss

Greg, how far along are you in reallocating these titanium supply contracts?

Greg Hayes

Well, we are probably – in terms of identifying the sources and the contracts, I would say, we are almost complete. The issue simply is getting the parts qualified. You have got to go through a first article. You got to go through the metallurgical analysis. You got to make sure that the composition of material is exactly the same as what it was prior. And then you got to get the parts certified. So, that's the part that takes time. It's not actually identifying the suppliers. We have done that. We have got everything lined up. The same thing on heat exchangers. Recall, we made a number of different commercial heat exchangers in – at our joint venture in Moscow. All that work was discontinued on the 27th of February, and we are still working through the requalification of heat exchangers. And that's 787s, that's 777s, that's Embraer 170. There is a number of issues that are now – we have got coverage for titanium for most of those or for heat exchangers through the end of the year, and we are working through the requal there. But we are not done yet. There is a lot of work to do.

David Strauss

Thank you.

Operator

Thank you. Our next question comes from the line of Noah Poponak of Goldman Sachs. Your question please.

Noah Poponak

Hi. Good morning everyone.

Greg Hayes

Good morning Noah.

Noah Poponak

Obviously, what's happening with supply chain labor inflation is – it's unprecedented and hard to manage and hard to forecast. But I am confused by the pace of deterioration or the narrow window in which the defense forecast have changed because unprecedented and hard to manage and hard to forecast. But I am confused by the pace of deterioration or the narrow window in which the defense forecast have changed because the variances – the negative variances are pretty large. And if I go back to just the first quarter call in April, you are talking about supply chain labor inflation repeatedly, the whole world was. And so you were giving guidance just three months ago and a month into the quarter. And so have supply chain, labor inflation deteriorated that much in just two months to three months' time, or is it that it's just that difficult to forecast? And if it's the latter, if I go back to this discussion of the second half inflection, it's still really hard to stare at this RMD guidance and see how you can have that much of an acceleration. Maybe you could spend some time on the specific programs that drive that to get us more comfortable.

Greg Hayes

Yes. Noah, that is a great point. I would tell you, when we exited the first quarter, and we knew that we had seen supply chain challenges, specifically at RMD, and the thought was, and which turned out to be, of course, incorrect, was that most of the supply chain challenges were related to Omicron, and that's why we had ones in December or in January, but we really expect it as COVID receded into the background that we would see a quick recovery in the supply chain. And in fact, that was wrong. The labor challenges that we continue to see have not abated. And again, I think that is the challenge, and that's the reason we continue to struggle in supply chain. Inflation is a challenge, but we can measure it, we can work to overcome it. Not having enough people in the supply chain, that has proven to be much more difficult. And so again, we have gone through this, I would tell you, program-by-program, line item-by-line item in terms of what's in our MRP schedule. And there are some go-gets out there, but we have commitments from suppliers to hit these numbers. And I think that's the – that is the challenge is making sure that our suppliers continue to deliver on the recovery plans that they have laid out for us. I don't know, Neil, anything you want to...

Neil Mitchill

Yes, two points because there has been a compounding impact that we have seen in the second quarter and expect to persist. And one is with the slowdown of receipts of material. We got a different mix of output during the quarter, more development program focused, and our lower margin production contracts were the ones that received the materials. So, getting back to that fill rate conversation, you had the stuff that was coming in not being on the more profitable programs. The second piece of that, the knockdown effect of that is the absence of labor productivity in the shops. And so with the fill rates being down in that 50% range, we just did not get the benefit of rolling through labor efficiencies, which is the primary driver of the EAC benefits we typically see in a quarter and RMD has seen. Now in the second half, we expect some, not all of that, to recover. And so it is a tough hill in the second half. I think we have got the right resources to engage with suppliers and within the business and on the shop floors. But we are looking at this every day, and we do need to see a market improvement in productivity in the shops to drive that P&L benefit in the second half of the year.

Noah Poponak

Okay. Thank you.

Greg Hayes

Thanks Noah.

Operator

Thank you. Our next question comes from the line of Sheila Kahyaoglu of Jefferies. Your question please, Sheila Kahyaoglu.

Sheila Kahyaoglu

Okay. I could I guess that was me. Good morning guys.

Greg Hayes

Good morning. Hi Sheila.

Sheila Kahyaoglu

Hi. When we think about the U.S. airlines, just pushing gears a little bit, they are finally seeing pricing tailwinds and capacity constraints. So, can you talk a little bit about your aftermarket business? Are you seeing different actions from the airlines? How is pricing trending relative to history? And then can you maybe remind us of your aftermarket guidance expectations for the year with long-haul international expectations for the second half?

Neil Mitchill

Sure. Let me start with some of the outlook pieces here. First, at Collins, we now expect aftermarket to be up between 20% and 25% year-over-year. So, we are at the halfway mark of the year. I think it's important. I have been talking a lot about the uncertainty around the recovery, and we are pleased to see that improving, obviously, and holding. I think Greg will probably want to add a couple of comments here as well. But clearly, the demand for air travel is very strong. We are seeing some encouragement in terms of the wide body routes opening up as well and expect that to continue in the second half. And on the Pratt side, we now see the aftermarket up year-over-year 25%. So, really good performance there. Our customers are giving us good line of sight to shop visit inductions. We are a little over 40% towards our plan for the year in terms of V2500 shop visits. There is still some work to be done in the back half of the year. As you know, China was closed down for the better part of the second quarter, and that is a piece of the back half growth. But we feel pretty confident. We have got a good dialogue with our customers, good line of sight to the third quarter in particular, and I expect that to continue in the fourth quarter.

Greg Hayes

Yes. Sheila, all I would say is that it's an interesting time for the commercial aerospace business. Demand is – unprecedented is the wrong word. I would say the trajectory of the recovery certainly I think caught people by a surprise in terms of the desire to travel again. And you can tell every time you go to an airport today the long lines that we have. And the problem, of course, is it's not just pilot shortages, but it's baggage handlers. It's TSA agents, it's everybody that supports commercial airlines. They are struggling with the same labor availability that we talked about in the supply chain. So, the recovery is very strong. Pricing, as you know, for the airlines is very strong. Fuel prices, Jet A has doubled in price in the last year. But it's come off of its eyes a couple of months ago. So, I think again, the airlines financially are doing very well. And the biggest concern they have is aircraft availability. And so we are going to see very strong inductions into the shop. We have seen very strong orders in our aftermarket and getting a little bit stronger than we had anticipated going into the second quarter. And we don't think there is anything that changes that trajectory in the back half of the year. Absent a huge resurgence in COVID, I think again, people want to travel. China will reopen at some point, which we have seen a quick snapback in demand as soon as China reopens. So, I think it's all pointing in a positive direction on commercial aero for the back half of the year and into 2023. So, I think again, we are well along the recovery path and no change in trajectory.

Sheila Kahyaoglu

Great. Thank you.

Operator

Thank you. Our next question comes from the line of Peter Arment of Baird. Please go ahead Peter Arment.

Peter Arment

Hey. Good morning Greg, Neil and Jennifer.

Greg Hayes

Good morning Peter.

Peter Arment

Greg, if I could just come back to kind of the differences between commercial aerospace or your aerospace business, how well it's performing, but dealing with a lot of the same probably supply chain that overlaps with defense. Maybe if you can just call out maybe some of the differences? Because I think a lot of it is struggling on the defense side, it really seems very complex and trying to get back to kind of the trajectory versus where your commercial aerospace business is. Probably dealing with a lot of the same challenges, but at the same time is performing really well. I mean maybe just call out a couple of differences that would be helpful. Thanks.

Greg Hayes

Yes. Look, one of the – one of the benefits on the commercial side is we are not handicapped with government contracting regulations. And to that end, the MMS, material management system, which dictates how much inventory we can drive and how soon we can place things on order, really constrains our ability to be flexible on the defense side. I would tell you the reason that we have been able to be successful on the commercial side is we have driven a lot of inventory in. You look at the inventory, it's up about $1 billion since the beginning of the year. It's up about $400 million in the second quarter, primarily on the commercial side to meet the higher demand. So, we have been driving material in faster. We are not constrained on the commercial side by the MMS system. And I think again, that is a lesson learned for us. And what we told the team in defense is bring it in. We don't have to build it. We had to bring in more inventory sooner rather than within normal lead times, that's okay. So, we are going to go out and be a little more aggressive with inventory. We are not talking billions of dollars, but the fact is we need to drive inventory in faster and give some surety of supply or surety of demand rather to our supply chain, such as they continue to drive material in. And look, some of the suppliers we know are not going to get better this year. Rocket motors, we have talked about that continually for over a year. We know that's a recovery that stretches probably into 2024. But that's only a piece of the problem. I mean it's again trying to make sure we have got the right chips and microelectronics and really hand-to-mouth there. But again, we have the tools. And again, the folks here at the corporate office and supply chain are off working with the folks on the defense side to help overcome some of these challenges, but it's not easy.

Peter Arment

Appreciate the color. Thanks Greg.

Greg Hayes

Thanks Peter.

Operator

Thank you. Our next question comes from the line of Robert Spingarn of Melius Research. Your question please, Robert Spingarn.

Robert Spingarn

Thank you. Greg, I wanted to go back to the discussion on inflation and labor constraints and ask what the longer term opportunity is to apply automation across the four businesses to mitigate these issues. Does this require brand-new programs or brand-new facilities to implement? And more specifically with Asheville, it seems that, that's going to be a tough labor situation. It's an inherently labor-intensive business casting, and you don't really have an available labor pool there that's trained in casting. So, how do you staff that plant specifically, or will it be more automated?

Greg Hayes

Well, look, it's – I would tell you, factory automation is something that we have been doing for a number of years. I think about the facility we have at Pratt Canada that went online more than 5 years ago, completely lights out manufacturing. So, we have been making investments, I will call it, an industry 4.0 across all of our factories. We have got the new project down in Dallas, the new factory, automated factory that's going in down there. You have got Asheville. And Asheville, while it is a large facility, the actual number of employees is only I think about 800 that we are going to be hiring, and we have been actively hiring them today to train them for the opening, which has happened sometime I think at the end of next year. So, look, it will be a challenge. But I would tell you, again, if you work at Pratt & Whitney, work at Collins or anywhere we across the RTX portfolio, we pay very good wages. But labor cost is a very – or direct labor cost, a very small piece of our cost of sales. The bigger challenge I would tell you is on the engineering front. And again, that's – it's just trying to find enough qualified engineers with clearances to drive the revenue growth that we have been expecting on all of these programs that we have signed up for. So, inflation is a problem, but we can deal with the inflation. The fact, labor shortages, we can deal with it within our own four walls because we have got really good pay, really good competitive benefits. People come to Raytheon because of our mission. And I think that's a differentiator that we have in the marketplace. And the hope, of course, is as we see the economy slow down here in the coming months and perhaps year, that we will have the opportunity to continue to drive more folks into both the shop floor as well as into our offices on these programs. As far as automation, we are going to continue to drive automation. It's what we do to drive cost reduction that we are encouraging suppliers to do the same thing. But it's all contemplated, I think in the kind of $2.5 billion a year that we spend on CapEx, which is not an insignificant amount.

Robert Spingarn

Greg, just one more thing on Asheville. You mentioned structural castings earlier. We know that it's been a long pole in the tent here. If I remember correctly, Asheville is supposed to be for airfoils, but might you do structural large structures there just to address this single supplier problem.

Greg Hayes

Yes. Look, we will take airfoils first. And I think, again, whether we decide later on to go up the supply chain there, that's a decision in another relatively large investment. The fact is structural castings require huge capital and I would tell you a workforce that is highly skilled. We are going to start with airfoils. It will take us several years to get up to full run rate production there, and then we will see where we go from there. But really no plans to go beyond structural – I am sorry, to go beyond the airfoils at this point.

Robert Spingarn

Thank you.

Greg Hayes

Thanks.

Operator

Thank you. Our final question comes from the line of Seth Seifman of JPMorgan. Please go ahead.

Seth Seifman

Yes. Thanks very much. Good morning. Thanks for all the color on the defense situation. Maybe just a quick final question that's a little more thematic. Greg, how do you think about the role of the company in China over time and the pace at which maybe the U.S. and China are decoupling on aerospace? We see the 737 MAX that it seems to be stuck in some political limbo right now in China, Collins as a supplier on the C919. How fast do you see these two kinds of aviation worlds is splitting up, or is that not the right way to think about it? How do you think about that these days?

Greg Hayes

So look, China remains an incredibly large market for commercial aerospace, is an incredibly important market for commercial aerospace growth over the coming decades. Obviously, the Chinese have a desire to have indigenous aircraft. That's the C919, maybe the C929 at some point. But the fact is, we think we are going to have – we will continue to work with our partners there. We will continue to utilize supply chain out of China that we have thousands and thousands of parts that come out of China for our commercial aerospace, specifically at Collins, but also some for Pratt Canada and some for Pratt & Whitney. So, look, we are going to continue to work with the Chinese. At the same time, I think we understand the geopolitical realities, and we are also making sure that we have assured supply chain. So, we are looking to make sure we have second sources outside of China in the case that the geopolitical tensions were eye to the point where we are not able to access that supply chain there. That's a process that's been ongoing for well over 1.5 years and will continue for the next couple of years, again, thousands of part numbers to do that. But again, we don't see a decoupling of China from the world the way we have seen a decoupling of Russia from the world after the invasion of Ukraine. Again, it's – the economy of Russia, relatively small, China is the second largest economy in the world. The decoupling between China and the U.S., I think is impractical and almost impossible to imagine the consequences on the U.S. consumer, the U.S. economy, if we really try to decouple. So, again, the hope here is we find a path forward where we can work together at the same time understanding that we have competing interests. But at the same time, we are retaining a very large presence in China for the commercial aerospace, obviously, not on the defense side. But we understand what we need to do to protect our customers long-term.

Seth Seifman

Okay. Thank you.

Greg Hayes

Okay. So Latif, thank you very much. Appreciate everybody listening in today. Jennifer and team, of course, will be available all day to take your calls and questions, and look forward to seeing you guys sometime early in the fall. Thank you.