Howmet Aerospace Inc. (NYSE:HWM) Q3 2022 Results Conference Call October 31, 2022 10:00 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

Robert Spingarn - Melius Research
Gautam Khanna - Cowen
Elizabeth Grenfell - Bank of America
David Strauss - Barclays
Myles Walton - Wolfe
Seth Seifman - JPMorgan
Kristine Liwag - Morgan Stanley
Noah Poponak - Goldman Sachs
Matt Akers - Wells Fargo

Operator

Good day, and welcome to Howmet Aerospace Third Quarter 2022 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] And please note that this event is being recorded.

I would now like to turn the call over to Paul Luther, Vice President of Investor Relations. Please go ahead.

Paul Luther

Thank you, Cole. Good morning, and welcome to the Howmet Aerospace Third 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 today's presentation, references to EBITDA and EPS, meaning adjusted EBITDA, excluding special items and adjusted EPS excluding special items. These measures are among the non-GAAP financial measures that we've included 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, P.T., and welcome everyone. Let's move to Slide 4. Howmet continued to perform well in the third quarter, earnings per share were in line with guidance midpoint and EBITDA margin was strong at 22.5%. Revenue, EBITDA and earnings per share, all grew for the fifth consecutive quarter. Q3 revenue was $1.433 billion and was factually lower compared to the midpoint of guidance of $1.44 billion.

All aerospace segments showed strong performance with sequential growth in the third quarter. Commercial transportation was lower reflecting normal seasonality and the effect of the wheels [indiscernible], which has now been resolved and production at the site brought back fully online as of the third week of October.

In September, we saw Commercial Aerospace customers rebate their schedules, notably in engine products, reflecting two dynamics. Firstly, a lower narrow body engine build over the summer and early fall than was originally envisaged, and due partially to the availability of structural castings. And secondly, customers bringing airfoil inventory levels in line by year end. I'll provide further commentary in the outlook section of my remarks.

EBITDA was $323 million and further progression on Q1 and Q2 of the year. Free cash flow was positive as forecasted, however, impacted by carrying higher commercial aerospace inventory levels, again, due to the scheduled rebalances of our customers. Q3 ending cash was a healthy $454 million after repurchasing approximately 2.8 million shares for $100 million at an average price of $36.17 per share and also paying the quarterly dividend. Legacy pension and OPEB liabilities continue to be reduced, which resulted in a reduced year-to-date cash contributions of approximately 45%.

I'll now pass the call to Ken for commentary by end markets and by each business segment.

Ken Giacobbe

Thank you, John. Please move to Slide 5 for an overview of the markets. Third quarter revenue was up 12% year-over-year. The commercial aerospace recovery continued in the third quarter, with commercial aerospace revenue up 23% year-over-year and 7% sequentially, driven by the Engine Products segment and the narrow body recovery.

Commercial aerospace has grown for sixth consecutive quarter and stands at 47% of total revenue but continues to be far short of the pre-COVID level, which was 60% of total revenue.

Defense Aerospace was down 4% year-over-year, driven by continued customer inventory corrections for the F-35, which was in line with our expectations. Commercial Transportation, which impacts both the Forged Wheels and Fastening Systems segment was up 13% year-over-year driven by higher aluminum prices and higher volumes, partially offset by foreign currency. Finally, the industrial and other markets, which is composed of IGT, oil and gas and general industrial was down 2% year-over-year. Within the industrial and other markets, oil and gas was up 11%, IGT was down 2% and general industrial was down 9% on a year-over-year basis.

Now let's move to Slide 6. As usual, we'll start with the P&L and the focus on enhanced profitability. In the third quarter, revenue, EBITDA, EBITDA margin and earnings per share were all in line with guidance. Revenue was up 12% year-over-year, including material pass-through of approximately $70 million. EBITDA was $323 million, and EBITDA margin was a healthy 22.5%. If we exclude the $70 million impact of higher material pass-through, EBITDA margin was 120 basis points higher to 23.7%. Adjusting for material pass-through, the flow-through of incremental revenue in the quarter to EBITDA was strong at 39%.

During Q3, we continued the recruitment of headcount by approximately 350 employees primarily in engines. Year-to-date, we have increased headcount by approximately 1,575 employees focused in engines and fasteners. In Q4, we do not expect significant headcount additions. Adjusted earnings per share was $0.36, up 33% year-over-year. For the quarter, the impact of foreign currency was minimal.

Moving to the balance sheet. Free cash flow year-to-date was $130 million, including an inventory build of approximately $270 million primarily for the commercial aerospace recovery. Cash on hand was healthy at $454 million after buying back $100 million of common stock and funding the quarterly dividend. The average diluted share count improved to a Q3 exit rate of 419 million shares. Year-to-date, net pension and OPEB liabilities were reduced by approximately $85 million and cash contributions were reduced by approximately 45% or $35 million.

Discount rates continue to be favorable and will be remeasured at the end of the year, which should further reduce net pension liabilities. We continue to expect annual cash contributions to be approximately $60 million versus expense of $20 million. Finally, net debt to EBITDA remains at 3x, all bond debt is unsecured and at fixed rates, which will provide stability of our interest rate expense. Our next bond maturity is in November of 2024.

Moving to capital allocation. We continue to be balanced in our approach. Capital expenditures continue to be less than depreciation at approximately 65% in the third quarter. Productivity CapEx continues to focus on automation products, projects in the engines and fasteners business to improve yields, enhance quality, reduce outsourcing and mitigate labor risk. We purchased approximately 2.8 million shares of common stock in the quarter from $100 million. Year-to-date, we have repurchased approximately 9.7 million shares of common stock for $335 million with an average acquisition price of $34.60 per share.

Share buyback authority from the Board of Directors stands at $1 billion. Lastly, we continue to be confident in free cash flow. The quarterly dividend was doubled to $0.04 per share per quarter with the first higher payment to be made in November of 2022.

Now let's move to Slide 7 to cover segment results. Q3 was another solid quarter for engines. Year-over-year revenue was 14% higher in the third quarter with commercial aerospace up 30%, driven by the narrow body recovery. Defense Aerospace was down 5%, IGT was down 2% and oil and gas was up 11%. EBITDA increased 23% year-over-year and margin improved 200 basis points to 27.2%, despite adding approximately 260 employees in the third quarter. Year-to-date net headcount additions for the engine business was approximately 1,040 employees. While the headcount additions are preparing us for the future commercial aerospace growth, it does unfavorably impact near-term results due to the time and cost required to train new employees, which could take several months depending on the position.

Now let's move to Slide 8. Fasting Systems year-over-year revenue was 15% higher in the third quarter. Commercial aerospace was 24% higher driven by the narrow-body recovery, somewhat offset by continued production declines for the Boeing 787. Defense Aerospace was up 16%. Year-over-year segment EBITDA increased 8% despite the addition of employees to support future growth. Year-to-date headcount additions for fasteners was approximately 410 employees. Sequentially, EBITDA margin improved 180 basis points to 22%.

Now let's move to Slide 9. Engineered Structures year-over-year revenue was down 3% in the quarter. Defense Aerospace was down 14% year-over-year, driven by customer inventory corrections for the F-35 as expected. Commercial aerospace was 5% higher as the narrow-body recovery offset the impact of production declines for the Boeing 787. Segment EBITDA increased 8% year-over-year. EBITDA margin improved 140 basis points to 14.5% despite the inventory burn down of the F-35, continued 0 to low build on the 787 and inflationary cost pressures. Structures Q3 2022 EBITDA margin of 14.5% was greater than the 2019 annual rate of 14.2% and when 2019 revenues were over $1.25 billion.

Finally, let's move to Slide 10. As expected, Portsville's year-over-year revenue was 15% higher in the third quarter. The $35 million increase in revenue year-over-year was almost entirely driven by higher aluminum prices. Commercial transportation demand remained strong, but volumes continue to be impacted by customer supply chain issues, limiting commercial truck production.

Segment EBITDA decreased 11% due to the impact of unfavorable foreign currency, primarily driven by the euro. While the pass-through of the higher aluminum prices did not impact EBITDA dollars, it did unfavorably impact margin by approximately 340 basis points. The impact on EBITDA margin increases to more than 550 basis points if you also include the unfavorable margin impact of passing through higher inflationary costs like the European energy costs and the unfavorable impact of foreign currency.

Before turning it back over to John, I will remind you that the impact of foreign currency to Howmet in total is minimal as the Aerospace segments provide a natural foreign currency hedge against the Forged Wheels segment. Lastly, in the appendix, we've updated assumptions, including an improvement in the annual operational tax rate to approximately 23.5%, which translates into a Q4 operational tax rate of approximately 22%. Also, we have updated annual assumptions to reflect improvements in our cash tax rate, net pension liabilities, depreciation and amortization, CapEx and diluted share count.

Now let me turn that back over to John.

John Plant

Thanks, Ken. So let's move to Slide #11. First, let me comment on the wider picture in commercial aerospace. Recovery continues with increasing airline schedules and load factors, especially in Europe and North America. Airline profits are rebounding well, and new aircraft are being ordered, especially narrow-body aircraft. International travel has also rebounded during the year and is showing strength, which is leading to modest increased production as we move into 2023, notably Airbus A350 and the Boeing 787 after its recent recertification. Spares for the aftermarket also continued to increase. This trend provides optimism that aircraft build volume will continue to strengthen throughout 2023 and 2024.

Recent aircraft build rate issues have been more the result of parts availability, especially but not confined to engines. While we have to be cautious at this time, pending more visibility of unrestricted builds, allowing Airbus to reach their build levels of 55 per month for the A320, and Boeing to reach their build levels of 31 per month on the 737 MAX, we do envisage – envision that commercial aerospace revenue should be up around 20% in 2023. Consolidated Howmet, including commercial aerospace and its other sectors of defense, industrial gas turbine, oil and gas and commercial transportation is expected to be up approximately 10% plus or minus 2% in revenue.

Further refinement will be provided in February 2023 upon the release of Q4 earnings. In the more immediate time frame of Q4, we do envision further sequential growth. However, approximately $70 million of lower revenue compared to previously envisaged primarily in engine products as a result of the lower engine bill achieved and customer inventory drawdown or the end of year toward my earlier comments. This results in an annual guide of $5.62 billion due to a small offset in other business areas beyond engine and earnings per share of $0.38 in the fourth quarter, which again is another sequential increase as we've shown in each quarter of 2022.

Higher inventory will now be needed at year-end to accommodate the snapback and increasing build starting in the first quarter of next year once we've got through this inventory correction. More specifically, the guidance for Q4 is as follows: revenue, $1.47 billion, plus $30 million, minus $20 million; EBITDA $330 million, plus $6 million, minus $5 million; earnings per share of $0.38, plus or minus $0.01.

For the full year, revenue of $5.62 billion, plus $30 million, minus $20 million; EBITDA of $1.27 billion, plus $6 million, minus $5 million; earnings per share of $1.40, plus or minus $0.01 as we've narrowed the range from previous guidance. Free cash flow of $560 million, plus $20 million, minus $40 million, and this is driven -- this reduction compared to prior guidance is driven by the higher year-end inventory carried into 2023 for the continued commercial growth -- aerospace growth in the first quarter.

Let's move to Slide 12 for summary. 2022 is another solid year with increases of revenue and profit building in each quarter and sequentially into Q4. Momentum does continue into 2023 with commercial aerospace expected to perform above normal growth rates in 2023, 2024 and also 2025 before reverting to a more normal 4% per year growth for Aerospace. We look forward to the future.

So let's now take your questions.

Question-and-Answer Session

Operator

[Operator Instructions] And our first question today will come from Robert Spingarn with Melius Research.

Robert Spingarn

John, there seems to be a bit of a disconnect in commercial aero and the messaging from Boeing and Airbus. So engine deliveries for Pratt and CFM were up significantly.

And Airbus has the OEMs, the engine OEMs are catching up. But Boeing says -- talks about the bottleneck, which you referred to earlier. So are you seeing more volumes for LEAP-1A versus LEAP-1B, how do we make sense of this difference that we think is occurring on the LEAP?

John Plant

Okay. So First of all, let me agree with you that it is confusing, I think it's confusing for everybody at the moment. But let's start off with the broad picture and then talk about Howmet before any commentary on a wider basis.

So I think the big picture is commercial aerospace continues to grind higher. Everybody is trying to do the right things. And airlines are improving. I think aerospace manufacturers are improving their throughputs and the engine manufacturer supporting those aircraft builds are also doing their part of the whole thing. I guess not everything is going perfectly, as we've seen from some of the numbers and some of the disconnects apparent from commentary on calls last week.

Let me deal with Howmet first and say, we've been really well prepared through the last year and beyond. As you know, we started recruitment of labor in the second quarter of last year and hired almost 1,000 people last year. Through year-to-date, I think we're approaching now something like 1,500 people through the end of the third quarter. And then I think the most salient factor for ourselves was that during September is that compared to the schedules and delivery requirements that we thought we would see for both September and the fourth quarter, we saw a complete rebasing of those requirements where we've had arrears which should be built up according to, I think, the anticipated engine mills, in particular. And as we know, the anticipated engine builds were not as high as -- the actual is not as high as anticipated.

And you saw Airbus commenting on the fact they had lied us in the like 70 at one point, then it was down to maybe 10 or 20. So while I'll say deliveries of engines did improve, I don't think anybody believes that the quantity of engines that was originally envisaged to be built were built.

In terms of the splits of whatever was delivered on LEAP between 1A, 1B, 1C, we don't have any visibility into that. I mean we do note that from the call last week from GE Aviation, which provides a lot of those engines is that they were significantly up with an improved deliveries, I think, in the near 350 engines. How many went to Airbus, how many went to Boeing, COMAC. And indeed, how many of those engines, which we also -- you sometimes forget they go to airlines or spares and also aircraft leasing companies or spares, I don't really know, it's difficult to judge.

Certainly, you feel as though there was enough engines in the whole system, but maybe they were out of parts of the -- difficult to really know. Nevertheless, the big picture is those actual builds both by CFM engines and LEAP engines were less than a bit envisaged. And I think we've heard in the past about restrictions around structural castings in particular, probably not confined just to that. And therefore, when customers looked at where they were and what they expected to finish the year with and also where they had received from ourselves, for example, all of the airfoils they required and more maybe is to balance their own inventories for the end of the year is that they were cut back. And so despite still sequential growth quarter-on-quarter that growth is not as high as we had envisaged.

So right now, we've drawn our labor recruitment down significantly. So we'll be -- probably recruit selective in a few areas in the fourth quarter. Essentially, the rest will go to 0. And because we don't want to certainly stop production, we're going to carry about $70 million of additional inventory, which will hit our cash balance at the end of the year. And as we need that that inventory to carry us through into the first quarter where we do expect those requirements will be placed back on us significantly, engine build will improve, and hopefully, aircraft production will improve.

And so we're trying to smooth ourselves out. So we'll utilize all of the labor that we've recruited, carry on with production, put it into inventory. So we have a smooth startup into the start of next year. So we keep all of our customers happy. But it does enable us to stop ourselves hiring a lot of people, and so we will eliminate some of that cost, albeit, as you can imagine, we were holding that cost in the month of September than we are into the balance of the year.So that's the big picture.

In terms of exactly what the rate of production of the 737 is and the A320, I don't think we are best placed to answer and I believe that most people are heading off on the sell side to Seattle this week so you really get a clearer picture during those visits. So I don't know, whether that covers it out for you, rob, but just trying to give you a sweep through the whole situation.

Robert Spingarn

That's really helpful, John. And even with what you just said, and I am heading out there with the others. Just on the 87, are you still looking for 15 shipsets for this year? And do you have any insight into next year?

John Plant

We have a revised skyline for next year. We don't have much for this year. I think it's going to be de minimis of any production on the 87. My guess is it's probably just about month that we've seen previously. I don't really know. It's pretty opaque to us. And I'm assuming there's inventory in the system for that.

We do have skylines showing clear improvements on the 787 build during the course of next year. And I think from memory, it's probably the back end of the year at around about 5 aircraft per month. And I do have confidence that there is a market requirement for that because when I look at the return of international demand for travel, just look at, I'll say, the cutbacks that were made in widebody during the last few years, then if anything, my guess is that there's going to be a higher demand on wide-body, which will support a rate for both Airbus and for Boeing for their A350s and 787s above that rate.

So I'm actually tending towards the optimistic side of fundamental demand. And then the only question that we have is, in terms of our own guidance is how conservative should we be because we do hear this noise that you referred to about exactly how many were made and where that parts are and what are the constraints. And so that also causes us to be just a little bit cautious given the factors that we've encountered in the last month or 2 enrolling into the end of the year, albeit against we see that spiking up in the first quarter.

Operator

And our next question will come from Gautam Khanna with Cowen.

Gautam Khanna

I wanted to ask if you could talk about share gain opportunity. So anything incremental on titanium? And are any of these pinch points on engines accruing to your benefit where customers are engaging on castings reported. If you could speak to that?

John Plant

In the -- I mean, the biggest pinch points for engine we would like to think has been around the structural castings. There's probably some engine controllers as well, but I don't really know that. It's probably lots of other things, which I'm not fully aware of. But I think the commentary around structural castings is pretty widely publicized.

In the short term, it doesn't really -- it presents an opportunity to us because there is a specific tooling and certification procedures which are required. And so it really is a case of getting the structural castings from the relevant supplier.

In terms of ourselves, while we have been tighter than we'd like on structural castings is that we don't believe that we've caused any engine build issues and indeed beginning to see in that segment significant improvements in our throughput and abilities. And its not quite as good as the flow of air flows that we've been seeing because that's been a really, I'll say, high-class output for us during the year. But short term, nothing we can point to, I think, in the medium to longer term, we will see benefits on the structural casting side across the various sectors of the industry. But nothing for us to put into a, let's say, 2023 planning at all.

On titanium, which was your other question, is that those orders continue to improve. So we've booked additional orders for -- during the third and fourth quarter, and that's looking better for us, albeit there's still significant areas to go because we still have, in particular, 1 of the airframe manufacturers, which has got a lot of inventory and hasn't really yet moved to cut orders lease on the supply base. So more to come on that subject as we move into next year.

Operator

And our next question will come from David Strauss with Barclays.

David Strauss

John, so to try to simplify this. Are you at 31 a month on the MAX on the engine side, are you at 45 to 50 on the engine side for Airbus. And this just really has to do with a shortage of other parts. And as a result, the manufacturers kind of slowed down things to get everything aligned given that they're building below the rate that you are currently producing at?

John Plant

Yes. We've been building at rates. So we've taken the requirements from our engine customers and the airframe manufacturers, and we've just been more or less in line with that, I'll say, 50-plus for A320s as an example. Probably with some attempted inventory for the infill rate build increases next year. And in the case of Boeing, we were fully planning on the 31 a month and had anticipated that those according to, let's say, verbal communication, not any scheduled commitments, originally, were planned to rise during the first quarter of 2023.

As we all know that those production levels probably have not been achieved and the airframe manufacturers and certainly on the engine side, and so where we've been in line at or even, I would say, meeting for rate increases next year is that, that inventory is being taken back out of the system to bring it down to what actually has been produced and the requirements seen for, in particular, the engine manufacturers towards their own year-end and the inventory that they're carrying. So there’s point in carrying say, additional air flows when you have some of the other parts to go with the engine. It's pretty -- simple, David.

David Strauss

And John, do you see, at least from your side where you sit, any constraints, whether it be hiring additional headcount, training headcount, raw material, anything? Do you see constraints to go up to the mid-50s to 60 that Airbus is talking about on narrowbody and Boeing going up to, let's say, low 40s? Do you see a constraint from your side of things?

John Plant

Not from our side. We think our tight quantity in structural castings have been or are being addressed and so that's in good shape. We are going to pull back on our hiring, as I said, again, selectively. So we will continue, for example, hiring and training in our structural casting plants. But at the moment, if you take our airfoils, we will just stay with the labor we had at the end of the third quarter and pause it to balance our own requirements. So far, we've been able to increase our quantity of people, and it hasn't really presented a great impediment to us. Sometimes the turnover of those people has been higher than we'd like, but the quantity of labor has not been an issue for us so far.

Operator

And our next question will come from Myles Walton with Wolfe.

Myles Walton

Looking sequentially into 4Q, it looks like you're looking for a $4 million EBITDA growth on the $40 million of sales growth. Just curious, is that lower incremental driven by something like FX or mix, it sounds like labor is probably a help and raw material pass-through might be a push?

John Plant

So can you start the first sentence again, if you wouldn't mind?

Myles Walton

Yes, sure thing, John. So if I just look sequentially from 3Q to 4Q, you've got pretty minimal EBITDA growth, about $4 million on the $40 million sales growth. I'm just curious the holding you back if labor and raw materials and pass-through aren't the issue?

John Plant

So let me start with commentary regarding the third quarter first. I mean adjusted for the material pass-through, incrementals were really strong at 39%which was above the, I'll say, the midpoint of where we talked previously, you said 35% plus or minus 5%. So I think that was a really strong quarter. The reason why we are being cautious about our fourth quarter is that we're carrying that labor into the fourth quarter that we probably don't need now for that reduced level of build. And so there's a labor drag plus also in the preparation of, I'll say, a lot of other production parts and facilities that could go along with that. And so that's the reason why you're not seeing the same level of incremental pull-through in the first -- I mean, in the fourth quarter.

So I think you should look at that just as a rebalancing of ourselves as we have drawn down that $70 million plus of engine products, which is a high-margin business for us. And so I think it's completely in line with the commentary I've given.

Myles Walton

Okay. Fair enough. And then in that 10% growth sales in '23, do you have a flavor for what we should think about from incremental margins there?

John Plant

I think we'll talk more about that in the February call. I know that last year, I gave a revenue guide, I thought it was important for '22. I think the same is important. So we really understand the wider picture around the company. And having the confidence that we should be anywhere from, I would say, 10%, plus or minus 8% to 12% is a statement of confidence in that we're on trajectory and we're only just debating the angle of the recovery, either which rates above the normal for aerospace, if aerospace is normally 4% or 5%, it's more than double that rate. And so it's pretty healthy. But not -- we're not ready to give any margin guidance at this point.

Operator

Our next question will come from Seth Seifman with JPMorgan.

Seth Seifman

John, I wonder the -- so the 10% growth outlook for next year if aerospace is growing 20%, and that's, let's say, 45% of the sales base this year, it implies really minimal growth in the rest of the portfolio. So if you could just talk about the -- what's happening in the other end markets? And then specifically, maybe help us around forged wheels. I mean between the currency and energy pass-throughs and aluminum pass-throughs, there's a lot of ups and downs, especially in terms of the revenue numbers and the margin rate. But if we think about the baseline of EBITDA dollars there and what this quarter says about what that might be going forward, any help there would be appreciated as well?

John Plant

Okay. So in terms of the defense business and oil and gas and the industrial gas turbine, I think all of those will see at this point, a low single-digit growth. And my guess is that maybe oil and gas will be higher, maybe defense below, but still expecting some growth in those. So if you plan for that and lay it across with the commercial aero, then the 1 segment where I think we're going to see a revenue decrease will be in the forged wheel business for the Commercial Transportation segment.

So let me try to explain what we see there. I mean the first thing is, of course, the headline number is affected by the price of aluminium, because as aluminum has fallen during the course of this year from its peak of $4,500 a ton, including Midwest premiums or Rotterdam premiums is that it's more like probably $2,800 now. And as we rebalance the pricing because we will pass that back, then you get a couple of effects of those new prices going into effect on the 1st of January is that there is a revenue decline, which doesn't affect the EBITDA dollars, and therefore, there is a margin rate improvement from that.

At the same time, let me think about what do we expect by way of volumes? We do note that the order intake, for example, for Class 8 truck was the highest it's ever been in a September, I think, 53,000 plus trucks, which is really, I'd say, great number, probably inflated by the fact that many say, the truck manufacturers haven't been willing to take orders for next year until they were clearer regarding the input prices of their materials.

So it's difficult to separate out what's really going on, except that the fourth quarter should see solid production improved compared to we've been, and I think that will continue in the first and second quarters next year. And my caution at the moment is in the second half of next year when I think we'll see the effect of the higher interest rates bear on the economies, in particular in Europe, which is overlaid with energy prices. And so I think there will be a dampening of demand. And it's probably around more the distribution and the trader segment of the business.

And so my anticipation is that second half of next year will be a tougher comparison to the second half of this year. And I mean, obviously, it's only speculative at this stage because I want to be cautious about it. But I think the correct planning assumption is solid performance through the next 3 quarters then anticipate a bit of a drawdown depending on how the economy is really doing. And does it go into a recession or not and then try to make the assessment.

So the best I can do at this stage is that when I look at it, my guesstimate has been something like on a volume basis that we could be, let's say, I just -- can you give an example of the thought at the moment is on the year, maybe 300, 000 or 400,000 wheels down in volume. We will probably pull half of that back by additional penetration of aluminum versus steel, and I'll say another I'll say, programs, we have to increase our share.

But net, I'm thinking that a little bit of volume caution in the second half plus with the effect of the aluminum reduction, we'll produce a drawdown of revenue albeit the only effect on EBITDA will be that net drawdown of volume should it occur. And I don't think there's a reason to be optimistic and say, all is great, and it will continue.

I don't think it's going to -- we are going to be affected by the emissions legislation for '24 because there's an inability to build ahead. And so it's all down to that second half assumption of next year or so, which is just to guess on commercial wheels at this stage, nothing -- nobody knows. But the way I put it out there, it's going to be good.

If you -- so if you put that wheeling as a down at the other single digit in commercial, I think you can get to the guidance range of that 8% to 12%.

Operator

And our next question will come from Kristine Liwag with Morgan Stanley.

Kristine Liwag

John, you've been clear that you now have the labor in place to ramp up next year. So when you think about their training, you said 6 months or so, how much have they pressured margins to have labor this early. And how should we think about incremental margins next year when we actually get the benefit of volume coming through?

John Plant

Okay. Well, we're going to pause for the main in Q4 for recruitment, not totally. It will be 2 or 3 or 4 plants that will continue, but out of our complete network we are choosing to pause that at this stage until we know more and let the additional people that we've already recruited during this recovery, which is some, I'll say, 2,500 come up to rate and let that hopefully, productivity improve.

Depending on the job, it can take anywhere from I'm going to say, 3 months to bring in somebody into the plant and to be, I'll say, reasonably effective all the way up to 2 years and beyond for some skilled areas, and we have to move people around to try to balance all that out. So I think there will be a benefit for that stabilization. How much, its difficult to say at this stage. And it obviously depends on the growth next year. We will commence recruitment again in larger numbers in January as we expect the build rate to increase in January. We'll go to the first quarter taking some of it out of inventory, certainly fourth quarter, but we’ll continue then to restart and fire up to recruit people again. And so that's headcount availing. I'm not yet ready to give any commentary about margins for 2023 at this point.

Kristine Liwag

And maybe following up on the inventory build, the castings and the shortage in castings and forgings have been well publicized and the OEMs have been very clear that the strong demand for aircraft out there. I guess I would have thought that we'd be in an environment of full steam ahead for demand for your product. What's causing the uncertainty? And also with the $80 million inventory headwind that you highlighted in this quarter, when does this unwind? And where could peak balance be?

John Plant

I think everybody expected continued buoyancy as we did for increases in builds. I think they are occurring. It's only a question of degree. And as I said, if we haven't built as many aircraft has there been thought and there seems to be a case where that's correct, you're just going off the earnings calls last year from the airframe manufacturers. And while there's a notable and real improvement in engine build, it still is in aggregate, I think a little bit lower than people had probably planned for. And so I mean, everybody is trying really hard throughout the whole system. Airlines are doing well and improving, their trying hard and getting people and bringing aircraft back into service.

I think the engine manufacturers are trying really hard. Now I think the airframe manufacturers -- yeah, everybody's trying really hard to get up this ramp and deal with all the factors that they've had to cope with in terms of -- which starts with COVID and the supply shortages and freight rates and just training of labor and availability and then other, I'll say, impediments in other materials in the supply chain. So there's been a lot going on. So I think everybody is trying to do the right thing.

And I think all we're talking about here for Howmet is that where some of our parts are being brought into line with what they cash for elsewhere and maybe just a little bit of a less ambitious plan in terms of build rates just because I mean we -- I think you can see that probably we haven't built -- or there has not been as many MAX's built or maybe as many narrow-body Airbus's built as visually envisaged, is my guesstimate from trying to assess the information available from what's been said publicly on the earnings calls of all the companies.

Operator

Our next question will come from Elizabeth Grenfell with Bank of America.

Elizabeth Grenfell

How are the different customers prioritized in your queue? Are more profitable customers prioritized first? And then -- I'll start with that.

John Plant

Okay. No, we treat every customer, their requirements with equal respect. So there's no prioritization, I don't think that would be appropriate. You're either a customer and we make a commitment and when we do that, we deliver to you to the very best of our abilities.

Elizabeth Grenfell

Okay. So if you had a certain number to ship out and the demand was mismatched, there would be no prioritization in terms of who got what?

John Plant

No, I don't think so. I think we should, again, respect that there's a requirement our customers have placed on us. I don't think that we have a policy nor a plan nor even the ability. So if you think about our shipping docs, they operate to the MRP schedule, the customer demand and they ship. They don't say I'll stick a few extra boxes of parts to some because they're more profitable. The people who do that, they don't have that information. So no, we supply to that which we've committed and with no instruction to say, please send to this customer because they're more profitable now.

Operator

Our next question will come from Noah Poponak with Goldman Sachs.

Noah Poponak

John, could you maybe just give us a broader update on where your market share gain efforts stand? It seems like that's maybe happening in part related to these supply chain challenges across the engine supply chain and then also titanium sourcing. And I know you've talked about sort of being in different RFP processes and trying to write long-term contracts? And I'm curious how that's going.

John Plant

Yes. So as a more general note, we go through our own planning routines during the course of the year. And we try to run through in terms of review each of our customers and where those opportunities may lie. And then we have our planning round where we look at, so where is the best place to place resources, both engineering and then capital deployment. And with a view that our job as a set of executives is to basically grow above the market rates.

My view is that if we only grow at market rates, then we're not adding the value that we should be because we should be seeking to do more than that. And more than that, just noting in terms of margin performance, but in particular, the opportunity to grow our share or take content into Howmet. So that's the basic stance that we have, Noah. And then once we've got that on the see before us, all of the opportunities, then at that point, we can make our own resource decisions whether we allocate more capital to this area or in that area according to the prospect of returns for it. And clearly, at that point, then we resource allocate. So it isn't a matter of just bottoms up, we just -- there's a process where everybody wants more capital or more resources, everybody gets a fair shake on it. It's not that at all, it's more. These are all the opportunities. And then our job as the leadership of the company is to then determine how we allocate.

So whereas on the last question from Elizabeth, she was asking, do we prioritize in the short term and the immediacy of deliveries, no, we don't. But in the long term, absolutely, we do. So we do resource allocate to those different areas and have a clear process for doing so. And with the objective of meeting the target to be above the rate of normal increase for those end markets we serve.

Noah Poponak

Okay. And last quarter, I think you specified adding $20 million of revenue to the fourth quarter fairly specifically related to titanium sourcing. Any update on that specifically and how that looks beyond this year?

John Plant

It clearly continues to improve. We've booked more orders in the end in the third quarter into the fourth quarter, and that continues to be a positive for us. But it's still continuing, and we have 1 major manufacturer where we've engaged but still yet to really move in terms of any significant orders essentially because there's a lot of inventory of titanium in the system at the moment with that reduced wide-body build that we talked about.

So more to come. I'm hopeful that we'll give you some improved assessment in February. But at the moment, if we just -- just assume that we are on track to achieve that $20 million or slightly better for the fourth quarter, and it will continue to improve in 2023 and 2024.

Operator

And our next question will come from Matt Akers with Wells Fargo.

Matt Akers

Could you touch on the defense decline in the quarter, and specifically, I guess, the F-35, some of the inventory corrections you saw how much longer does that still have to go on?

John Plant

Yes. So our assumption is that Lockheed do produce somewhere in that $1.45 to $1.55 range this year. And if anything, probably let's say, just take the $150 million or a little bit less, is probably the -- our assumption, which will be an increase on the production in last year. We do note that the order intake for F-35 seems particularly strong. And so that 150 plus rates should continue, we think, probably for the rest of the decade. And so that's all good news.

For us specifically, because for the last 2 years of 2020 and 2021, we did produce at a higher rate for the customer sort of schedule requirements anticipating as they did, I think they would make closer to the 150 aircraft. And as we know they produced probably in that 130 to 140 range and therefore, they carry the inventory into this year, which we said we would correct for the most part, during 2022. So in particular, for the airframe and bulkheads part of the aircraft is that we've seen that downdraft, and we've commented on that affecting our structures business, and Ken called it out again in Q3 as the major factor on the impact on defense sales that continued the inventory correction.

Our view is that, that will continue in Q4 and into Q1 next year, and we're hopeful that by the second half of next year, the latest is that we are in balance. And so our production will be coming up on the F-35 to match rate, which will obviously be a significant improvement for us. And if that's combined with the increase in rates for the 787 then we should see some very positive demand requirements for our structures business in particular. And that's also part of my expectation within that range of guidance given to you for 2023?

Matt Akers

That's helpful. And then if I could do 1 more on pension. I guess, I know you mentioned with a higher rate, but the liability, it's a little bit better. But I guess when you factor in asset returns year-to-date, is it meaningfully different kind of next year versus 2022?

John Plant

Yes. I'll pass that across to Ken to give you a little bit more color on that. But essentially, as interest rates have moved up, then that provides a downdraft on the liability side significance. Asset returns this year are lighter and lower than last year, and I don't have the exact numbers to hand, that will be a negative for that situation. And then when you put 2 together, is that along with the cash contributions we have made, we have a net liability reduction. And my anticipation is that we'll show further reduction of liability in the fourth quarter to make a meaningful change in the reduction of those legacy liabilities.

And I think on a net basis, we're probably down to I mean, I guess, around $700 million-ish plus or minus. So it's a pretty diminish number for the company now, very different than it was 2 or 3 years ago. But let me pass you across to Ken to comment specifically on the expected liabilities and assets.

Ken Giacobbe

Yes. So Matt, we've been doing a lot of work on the pension and OPEB program. So if you compare to where we are today, we've improved around $85 million in terms of net liability. A lot of that's driven by actions we started taking to clip off gross liabilities going back to Q2 of 2020, believe it or not, when we took out some U.K. buyout programs. But from Q2 of 2020 to current, we've taken off about $600 million of actions, right? So that's helping drive the net liability down.

But as John mentioned, at the end of the year, we’ll snap the line again in terms of where we're at. We get a nice favorability around discount rates because discount rates have moved from around 2.7% at the end of last year to mid-5% right now. So you're going to get a nice good guy on the liability side. To your point, the assets, if you even just track the S&P 500, they will be negative. You pushed the 2 of them together, though, you're going to get a nice reduction in terms of net liability. Also, we've got to get to the end of the year, but we anticipate cash contributions next year will probably be the same, if not less, based on all the work that we've done over the years.

John Plant

Maybe I'll just add to give you a bit of a broader perspective. So when I think about the environment we're in where interest rates are going up rapidly, and it's possible this week we'll see a further 75 basis points increase in federal funds rate. I mean that generally is bad news for most companies. In the case of ourselves on a net basis is that if I look at our debt then essentially all of our debt is fixed rate. And so it only can impact the refinancing of an exchange of bonds depending on what we've paid down of those bonds as well.

So I'm not anticipating that our interest rate costs go up at all in the next 2 or 3 years. So that's good. Our pension liabilities will go down, and that's good. And when I think about the markets we serve, I think we've already had our recession in the time of 2020, 2021 and the effects of COVID and then overlay that with the specific issues that Boeing had regarding production of C-737 and 787. And so we should be set for -- maybe uniquely as a sector set for growth for the next 2 or 3 years. And that growth should come through and our balance sheet should improve as a result of the interest rate movement. So it's a pretty unique and good set of circumstances. That's my optimism coming through.