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Ford Motor Company (F) CEO James Hackett on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-23-19 Earnings Summary

Press Release *Slides*

EPS of $0.34 beats by $0.08 | Revenue of $33.93B (-2.10% Y/Y) beats by $55.43M

Earning Call Audio

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Ford Motor Company (NYSE:F) Q3 2019 Earnings Conference Call October 23, 2019 5:00 PM ET

Company Participants

Lynn Antipas Tyson - Executive Director, Investor Relations

James Hackett - President and Chief Executive Officer

Tim Stone - Chief Financial Officer

Joseph Hinrichs - President, Automotive

James Farley - President, New Business, Technology and Strategy

David McClelland - Chief Executive Officer of Ford Credit

Conference Call Participants

John Murphy - Bank of America

Rod Lache - Wolfe Research

Joseph Spak - RBC Capital Markets

Brian Johnson - Barclays

Adam Jonas - Morgan Stanley

Operator

Good day, ladies and gentlemen. My name is Holly, and I will be your conference operator today. At this time, I would like to welcome you to the Ford Motor Company Third Quarter 2019 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] After the question-and-answer session, there will be closing remarks.

At this time, I would like to turn the call over to Lynn Antipas Tyson, Executive Director of Investor Relations. Lynn?

Lynn Antipas Tyson

Thank you, Holly. Welcome everyone to Ford Motor Company's third quarter 2019 earnings call. Presenting today are Jim Hackett, our President and CEO; and Tim Stone, our Chief Financial Officer. Also joining us are Joe Hinrichs, President, Automotive; Jim Farley, President, New Business, Technology and Strategy; and David McClelland CEO of Ford Credit.

Jim Hackett will begin with a brief review of the quarter and progress against our strategic initiatives. Tim will follow with a more detailed look at our results and then we'll turn to Q&A. Following Q&A, Jim Hackett will have a few closing remarks.

Our results comments today will include some non-GAAP references. These are reconciled to the most comparable U.S. GAAP measures in the appendix of our earnings deck, which can be found, along with the rest of our earnings materials at shareholder.ford.com. Actual results may differ from those stated, and the most significant factors that could cause actual results to differ are included on Page 22 of our presentation. In addition, unless otherwise noted, all comparisons are year-over-year.

As a reminder, in 2020, we will update the business units in our Automotive segment to align with changes to our management and reporting structure. To help you with this transition, our earnings deck appendix has a schematic of the changes including where certain joint ventures will be reported. Also, our revised 2018 and 2019 results show how they will appear in the new reporting structure. Investor relations team is available if you have specific questions about these changes.

Now I will turn the call over to Jim.

James Hackett

Thanks, Lynn, and hello everyone. Overall, the Ford team delivered solid operational results in the third quarter, while at the same time we made further progress on the global redesign of the company. We know though that we have much more work to do. As this is the mandate at Ford, executing in the now while transforming into a much more fit, agile, and customer-centric company that can win in an era of rapid change and innovation.

Our team is operating with urgency and a focus to meet these challenges. Please turn to Page 4. Now touching briefly on the quarter, we generated positive adjusted free cash flow. The year-to-date adjusted free cash flow was up 80%, largely driven by improvement in our Automotive business. In the quarter, we delivered $1.8 billion in company-adjusted EBIT.

That was up 8% supported by improvement in our businesses in China, North America, and Europe, as well as mark-to-market gains in corporate other and another strong performance by Ford Credit. In year-to-date EBIT for Automotive, it was up 10% and company-adjusted EBIT increased 6%.

Please turn to Page 5. At the highest level, our global redesign is about making choices to transform Ford into a more fit and competitive company. Simply put, we are absolutely committed to improving execution and addressing under performance throughout the company.

I will walk you through our business region by region. In our North American business amidst an intensified competitive environment, we are in the middle of an extensive product renewal. Reminding you that we are significantly refreshing and growing our SUV portfolio, introducing models like the completely redesigned Ford Explorer and Escape, and our all new Lincoln Aviator and Corsair.

And I am pleased to say that we are approaching now full production on the new Explorer and Aviator. This product renewal comes as we also phase out our most traditional sedan silhouettes. And again, our intent isn't to give up customers in that Sedan segment, rather to enhance their view of Ford's potential to please them in even a better vehicle.

We also plan to protect and expand our leadership in pickups and commercial vehicles. Look for a new Super Duty pickup in the coming months, and our all new F-150 next year. In a few weeks, we are introducing battery electric vehicles that's designed from the ground up to offer stunning performance, gorgeous design, and an incredible customer experience that is fully connected and updatable over time.

We also have big plans for the long awaited rebirth of the Bronco franchise. So, Ford is expanding into battery electric vehicles and rugged off-road SUVs, challenging brands that have had those two growth areas to themselves for long enough.

In total, I remind you that we are in the process of replacing 75% of our North American lineup by volume by the end of 2020, dramatically improving the freshness and appeal of our portfolio. The Ford team in Europe is making rapid strides in restructuring the business. We have reset our revenue and cost base and are rationalizing our product portfolio.

Europe is now focusing on three business groups; a strong and growing commercial vehicle business, a smaller and more profitable passenger vehicle business, and a niche portfolio of profitable and brand enhancing imported vehicles. So, going forward, you will see us redeploy capital to build on our position as Europe's number one commercial vehicle brand.

In addition, our country-specific product plans have us on track to deliver against the new European 2021 CO2 targets without penalties or fines using new hybrid and electric propulsion choices. We are clearly not satisfied with our standing in China, and the team is working exhaustively to return to profitable growth in this important market.

We are working to stabilize the business and are now launching new products that are tailored to the needs of Chinese customers. At the same time, we are attacking cost, reinvigorating our dealer network, and improving sales and market capabilities.

In South America, we are restructuring our operations to be far more asset light. And as you know, we made the decision to exit our heavy truck business. We reduced our management employee base by a full 20%, and we downsized our regional headquarters and rationalized the dealer networks in both Brazil and Argentina.

Finally, we recently announced the formation of our International Markets Group. We will refer to this as IMG, which brings together 100 high-potential emerged and emerging markets including India, Australia, ASEAN, the Middle East, Africa, and Russia. This is all under one leadership team. Emerging markets are growing at almost double the rate of the global industry.

By 2024, one in three vehicles in our industry will be sold in these markets. Having the right business model to profitably address this opportunity is critical, and that's precisely what IMG will do.

Now please turn to Page 6. An important enabler of the strategy is the agreement we reached earlier this month with Mahindra. The joint venture will help Ford profitably grow in India and unlock the low-cost product development capabilities we need to grow in emerging markets. Ford will benefit from Mahindra's lower-cost platforms and value-focused engineering.

Mahindra, on the other hand, will gain from Ford's global reach, quality, and technology, and that includes the battery electric vehicle. We are also taking strategic actions to prepare Ford to compete and lead in an industry that's being profoundly reshaped through connectivity, the sharing economy, automation, and new forms of propulsion. You can think of this as the smart vehicles for a smart world.

We are scaling products and businesses that connect to the world around them in ways that benefits customers. With all elements of Ford's Smart Mobility now in one organization led by Jim Farley, we are sharpening our focus on where to play and how to win across this broad mandate. We are not able to reveal all the work we are doing in this exciting and fast-moving era, but there are few things that I can share.

We are prioritizing investments in connected vehicle services that will improve the customer experience, and this will enable Ford to transition from what has been historically a largely product-led offering to an ever improving and much stickier suite of products, accessories, services, and experiences, all bundled together.

These investments have a sharp focus on customer data privacy and safety. They will open new opportunities to realize value from connected vehicle data and deliver outstanding experiences for our retail and commercial customers. And we'll have more to say about all of this in the future.

And as you know, we are also developing mobility services like Spin which is among the top three micro mobility companies in the U.S. with a footprint in 60 markets and growing and over three millions rides year-to-date, Spin is expanding Ford's reach and areas that we believe will contribute to an even stronger base for our Autonomous Vehicles businesses.

Speaking of AVs, last month, we announced Austin as our third market for our Autonomous Vehicle services. Together with Argo AI, we are currently mapping the city and we'll gradually increase the size of our fleet like how we are growing out operations in the first two cities, Miami and Washington DC. We are constantly learning from our expanding deployment of AV technology and services.

This space has shifted and evolved significantly even since the formation of our AV LLC in 2018 and we expect it to remain dynamic in the coming years. Our team is focused on building a successful, sustainable, and scalable self-driving vehicle service. And to this end, we remain focused on our plans for initial commercialization of the self-driving service in 2021 and we will begin to scale that service once we are able to remove the safety driver from the vehicle.

Before I turn the call over to Tim, let me address our full year outlook. We are experiencing more headwinds than expected in our fourth quarter. Especially, higher warranty, as a result, we have lowered our adjusted EBIT guidance range to $6.5 billion to $7 billion which suggests we will not grow adjusted EBIT this year as we intended.

Of course, we are disappointed in this. But we are confident that we are laying the groundwork for sustained improvement in profitability and cash flow over time.

In terms of warranty costs, we are feeling the downstream impact is from products designed earlier in the decade that we've taken extensive actions to improve long-term quality and durability including centralizing core engineering responsibility and bolstering our systems integration and design assurance processes. These actions are already bearing fruit as we are seeing an improving trend in quality studies on our models.

Now, let me turn the call over to our CFO, Tim Stone.

Tim Stone

Thanks, Jim. Hi, everyone. Ford's results this quarter demonstrate we are making progress and delivering on our commitments to customers and other stakeholders. However, it's clear, we have much more work to do. We are focused on consistently improving customer experience and operational execution across our business. We are making progress on a global redesign making the tough choices to lay the groundwork for improvement and future growth, free cash flow, profitability and returns on capital.

We are positioning forward to lead and win through fitness. For example, holding structural cost flat to down excluding pension and OPEB, and forming the JV with Mahindra. We are prioritizing meaningful opportunities for profitable, long-term growth in Mobility and disciplined execution is driving strong results from Ford Credit.

In the third quarter, we generated $207 million in adjusted free cash flow, year-to-date, adjusted free cash flow was up 80% to $2.3 billion supported by lower capital expenditures, higher distributions for Ford Credit and continued improvement in working capital in Auto business. Adjusted free cash flow is our most important financial measures and we are committed to generating sustainable growth over time.

Cash and liquidity of $22 billion and $35 billion remain above our targets. We remain committed to investment-grade credit ratings and a strong balance sheet. Wholesale declined 8% in the quarter, primarily driven by Europe, China and South America. Revenue was down 2% largely as a result of foreign exchange. Auto EBIT was $1.3 billion in the quarter with a margin of 3.9% as higher pricing and flat structural cost excluding pension and OPEB were offset by higher materials costs associated with product launches, higher warranty expenses and adverse currency exchange.

Our strategic investments in Mobility increased 48% as we continue to build out capabilities in connected services in Autonomous Vehicles. For the end of this year, 100% of Ford's new vehicles in the U.S. will be shifted to connectivity and we are targeting 90% globally by the end of 2020.

Ford Credit delivered another strong quarter, posting a 9% increase in earnings before taxes. Loss metrics reflected healthy and stable consumer credit and auction values for off-lease vehicles were slightly better than expected. We now believe auction values will be down about 2% on average for the full year and receivables were $149 billion.

Corporate other of $18 million included mark-to-market and other investment gains of $113 million including $77 million from pivotal software. On an adjusted basis, company EBIT increased 8% to $1.8 billion and our EBIT margin expanded to 40 basis points to 4.8% driven by improvement in our businesses in China, North America and Europe.

Mark-to-market gains in corporate other and another strong performance by Ford Credit. EPS is $0.34 and our tax rate in the quarter was 10.7%. In the third quarter, we recorded $1.5 billion in special item charges with cash effects of about $300 million. Actions related to our global redesign accounted for $1 billion in EBIT and a majority of the negative cash effects.

As expected, most of the third quarter global redesign charges were for an impairment in India related to the planned formation of our joint venture with Mahindra. Special charges in the quarter also included $300 million in non-cash pension remeasurement losses and a $187 million for an unfavorable customs ruling.

For the full year, we now expect to incur $3 billion to $3.5 billion of EBIT charges as a result of global redesign with negative cash effects of about $1 billion to $1.5 billion.

Let me touch in a few areas of the business in more detail. North America wholesale units were down modestly.

Launch-related ramp up of all new Explorer and Escape, the overlap of very strong production of F-series in the third quarter of last year to compensate for the decline in production volume caused by the Meridian fire and our decision to exit low-margin sedans were largely offset by the favorable impacts of our new Edge introduced at the end of 2018 and also Ranger. As a reminder, we plan to start production of the new Super Duty in the fourth quarter.

Revenue grew 5% supported by higher pricing and improved mix. EBIT increased 3% with a margin of 8.6% driven by higher pricing and volume in the U.S. which were partially offset by launch-related production costs and higher warranty expenses.

As a reminder, we expect to conclude our negotiations with the UAW in the fourth quarter and to recognize the full impact of ratification-related payments as part of our adjusted results.

In Europe wholesales declined 15%, primarily because of our redesign actions to exit low margin businesses, including discontinuation of the C-Max Sedan. Revenue which was down 14% or 9% excluding the impact of currency was also affected by the lower volumes.

At the same time, the benefit of Europe’s redesign were evident in the EBIT which improved 27% in the quarter. This is the first time in three years that Ford has posted consecutive quarters of year-over-year improvement in European profitability.

This performance is attributable to lower structural costs, stronger product mix and higher profits from our commercial vehicle JV Ford Auto. It was included to lower volumes and adverse currency exchange rates.

In China, wholesales declined 12% and consolidated revenue is down 27% as improvements in mix and pricing were more than offset by lower volumes, and component sales to the joint ventures in the country.

Our EBIT loss in China narrowed to $300 million, an improvement of $100 million year-over-year driven by lower structural cost and favorable market factors in consolidated operations. This is the third consecutive quarter of year-over-year improvement in profitability in China.

As Jim mentioned, we are working to stabilize our China business and working intensively to return into profitable growth. Deal engagement and profitability are starting to improve and we continue to keep production aligned to demand and ensure appropriate levels of dealer stock.

Please turn to Page 20. While our third quarter results demonstrate positive improvements in the trajectory of some areas of our business, we clearly have a lot more work to do. We are updating our outlook to reflect several headwinds that have intensified since the last gave guidance.

The first is higher warranty, particularly related to coverages; the second is higher incentives than planned in North America; and the third is China due to lower volumes and JV profits.

Taking these factors into consideration, we are now targeting a full year adjusted EBIT in the range of $6.5 billion to $7 billion, compared with $7 billion last year. This implies our fourth quarter adjusted EBIT range of $0.6 billion and $1.1 billion. We continue to expect strong market factors, lower full year auto structural costs excluding pension and OPEB, and strength in Ford Credit.

We still expect adjusted free cash flow to be up to the full year driven by our Auto business and we remain committed to driving growth in cash flow and profitability over time. We now expect the full year adjusted effective tax rate of around 12% to 13%, which is lower than our previous expectations, largely driven by more clarity on provisions in the U.S. Tax Cuts and Job Act of 2017.

This would yield adjusted EPS in the range of 120 to 132 compared with 130 last year. Relative to calls on capital for the year, we expect CapEx to be about $7.5 billion, down year-over-year reflecting benefits from our fitness initiatives, funded pension contributions to be about $750 million and shareholder distribution to be about $2.6 billion.

Our guidance assumes no material change in the current economic environment, including commodities, foreign exchange and tariffs. Our actual results could differ materially from our guidance due to risks uncertainties and other factors including those detailed in our filings with the SEC.

Before we move to Q&A, there are couple things that encourage you to keep in mind as you think about Ford, today and for the long-term. First, our customers are informing and driving everything we do.

That’s why 2019 and 2020 are such robust launch years for us in North America. We are bolstering our winning portfolio of vehicles, based on what consumers want and need, reallocating capital to those higher return growth opportunities and carrying out changeovers of our highest volume and most profitable vehicles. And second, we are determined to always get better to persistently focus on our fitness, and continuously improve our operating productivity.

While we see increased headwinds in our fourth quarter, we were biased for action and are intensely executing on the inputs that will enable us to capture the opportunities across our business that will allow us to drive free cash flow along with long-term growth in revenue and profitability including adjusted EBIT margins of 8% or better and we remain committed to maintaining a strong balance sheet and holding investment-grade credit rating.

Now, let’s open the call for questions. Operator?

Question-and-Answer Session

Operator

[Operator Instructions] Our first question comes from the line of John Murphy, Bank of America.

John Murphy

Hi, good afternoon guys and thanks for the call. Just a first question on to the rest of the year related to the fourth quarter, even when you back out the UAW bonuses, it looks like you're doing $1 billion, $1.5 billion in the fourth quarter.

So, it seems like it's a little bit on the light side, and you very specifically highlighted higher-than-planned incentives in North America. I am just curious are you seeing something on the competitive front where pricing is getting much more difficult, and it just kind of seems a little bit odd after you just posted a $700 million positive net price in the third quarter. Just it doesn't seem to match up with what you just did, so something changed dramatically in the competitive environment?

James Hackett

Hey, John, Jim Hackett. Let me ask Joe to bring you up to date on that.

Joseph Hinrichs

Hi, John. Thanks for the question. So, if you look at it, the simple answer to your question is, I wouldn't say there's anything dramatically changed in the environment at an industry level. Let me explain to you what's going on. For example in the third quarter, Ford's incentive increase year-over-year was slightly lower than what the industry average was for the U.S. market in the third quarter.

What's happening in the second half of the year, our incentives overall are slightly higher than we'd expected versus our plan for the year. That's largely driven by a couple of products. If you look at Ranger launch this year, it's gone very well. We had a – we've been regaining share every month this year, and we had 18% segment share in September.

But as you could expect the competitors haven't let us just grow that share without any fight, so we've seen a little bit higher incentives on Ranger than we had expected given the launch of the vehicle this year, still very optimistic about the product. It won APEAL, won IQS for JD Power, but the incentive spend on that product has been a little higher than we're expecting in the second half of the year.

If you look at what happened in the summer months, our competition on F-series was very aggressive; and so in September, we took some actions. We saw our segment share in F-150 come back up in September, and so we had to take some actions there. And Edge is in a very competitive segment, a little more competitive this year than we had planned for the year.

So, that's kind of where you look at it, but in general that's more us versus our plan for the second half of the year. But I was referring to the U.S. industry in the third quarter as a reference point. Incentives are still pretty much under control and the industry is behaving in a pretty rational way so far.

John Murphy

Okay. And then just a second question, and this might be a little bit more for Joe. But Jim, obviously I'd love to hear your view on this. There was a lot of concern around the Explorer launch, and it sounds like there was a lot of problems there, but it seems like you've got your arms around it and are ramping up pretty well. Just curious was that story overplayed in the press?

And we all got a little bit too concerned about that? And are there any lessons that you've learned for product launches, because obviously you have a ton coming down the pipe in the next 12 months from that process that you can apply going forward to kind of make sure we don't have this kind of kerfuffle or issues going forward?

James Hackett

I think I should – John, it's Jim Hackett, I think I should confirm that we have higher expectations for our performance and it's my experience in the short time that I've been here that Ford is really good at this. And so, Joe can add some color here, but the challenge, what I call the design problem is that we had to ramp down a really profitable vehicle.

We had to clear out the plant literally bulldoze everything out, build a new plant inside, get it started and not drop any volume in the midst of that. So, it was pretty aggressive and as I look at that, I want to win like that in the future. But we fell short in a few ways. In fact, Joe just took my whole team through a deep dive on what we've learned from that.

I was very impressed with kind of the granularity of what we do understand of how the things that should have gone better didn't. But what I am not concerned about is whether we get it and whether we have a grasp of how to get control of it. I'll let Joe share with you because of course we are getting daily updates, the latest status of where we are on Explorer.

Joseph Hinrichs

Yes, thanks, Jim. Thanks, John. So, really an important launch for us clearly, just to step back for a second, just so far this year, we launched the Ranger, all new in North America, very successful launch. Very unusual that it wins in its segment in IQS in the first year of introduction. Just launched Escape and Corsair down at Louisville, and that launch has gone very. It's gone and we are ahead of plan actually on that launch.

So the Explorer, Aviator launch is a very unique situation. As Jim said, we are disappointed in our overall performance in the ramp up of the volume. The products themselves are wonderful. The Aviator is a fabulous product. About half the sales of Explorer so far are FZ and Platinum, and if you haven't driven an FZ, really challenge you do so. It's a lot of fun and..

James Hackett

They won't give it back.

Joseph Hinrichs

Yes, so, you are right. So – but back to the launch, so, Chicago is our oldest plant. It was launched in 1924. It's very constrained as far as physical location and as far as land and area around the plant. Simply put, we took on too much. We signed up for too much at launch. We tried to launch on 3 crew, which we didn't even try to do when we launched the Aluminum F-150 back in 2014.

We launched the Aviator and Explorer both at the same time. We had the high reversion of Explorer. We had the Police Interceptor. We had Black Label Aviators. We had all this content and simply put with the new - with the product going from front-wheel drive to rear-wheel architecture, all new assembly line, all new body shop, all those things at once we took on too much and we shouldn’t have it.

And so, part of the lessons learned is obviously go back to how we manage these launches and sequence them in a way that gives the team a chance to be successful. Our wholesales were down in the third quarter about 19,000 Explorers year-over-year. And we also had an additional 6,000 aviators that weren’t in the year previous year.

And so, we feel really good about the fourth quarter. The last week or so, we’ve been running about 59 JPH. We are actually running out of parts from our suppliers as we’ve started to ramp up. We used to run at 60 JPH. So we are just about where we have been historically in that plant, plus we have the Show Center, the new additional line coming online starting about 6 JPH by the end of the month.

So, we actually feel really good about where we are right now. It’s been a lot of work and a lot to get here. The products look great. We have plenty of available inventory now in the dealers and we are excited about where they are going to go from here.

John Murphy

Okay.

Joseph Hinrichs

And for the rest of the launches, John, Super Duty launch looks good this year. Transit launch looks good this year. Puma in Europe looks good. We had a lot of work to do for next year's launches, but I feel good about where we are for the rest of the year.

John Murphy

Okay. And then, one quick last one on Ford Motor Credit, given the rate environment is shifting around on us in a direction that we expected 12 months ago, you had the credit downgraded Moody’s. Just curious, as you are managing Ford Motor Credit, has anything changed in the way you are thinking about the business?

And where are we on the shift of getting better return on assets on sort of a constrained, purposely constrained asset base? And could we see returns improve or profitability improve as soon as next year based on sort of those actions?

James Hackett

So, John, Jim Hackett. I am going to hand it to David McClelland. As an former bank board member managing through the crisis in this last decade, I am really proud of the Ford Credit discipline and in fact, our efficiencies improved. We aren't using more leverage to improve returns. So, we are very careful about that. But David, you can talk about and the great news we keep getting from Ford Credit.

David McClelland

Yes, John. Hi, this is David. So, I am echoing what Jim is saying. I am very comfortable with the way the credit company is going. The portfolio looks very strong. I mentioned this in the last earnings call and I haven't seen any change in that. We manage as you know, we manage our business. We've stated that we want to keep it around $150 billion.

We manage the leverage between 8 to 9 as Jim just mentioned. You guys know how much equity is employed in the business and you know that we expect to get and we made this quite public in 12% return on that equity. So, when you do the math, our expected earnings should be about $2 billion.

This year, we have had – you referenced it in your question, we've had good news, interest rate versus what we expected. So we have seen that in our DMV numbers and the used vehicle performance has been better than we expected. You've said now that we think the used vehicles will be down about 2% for the year. We are about 1.8% so far for the year.

I know that that's slightly different to what Manheim has said, but then I look specifically at the trend last year in used vehicles and I look at what happened in the fourth quarter last year. And then, most important we allocate the return mix and the Manheim is of the 2001 segmentations. When you look specifically at the Ford Credit return mix, I feel comfortable that 2% is about right.

So, overall – go ahead.

John Murphy

Yes, but is there been any shift in the portfolio so far maybe away from dealer floor plan financing to maybe a higher-margin retail business? I'm just trying to understand where we are in through that shift?

David McClelland

The floor plan in the U.S., the amount of floor plan we do in the U.S. is pretty constant. I would expect it to stay there. We do most of the floor plan in Europe. We haven’t seen a change in China. Our Fico is pretty constant on our sort of marginal business as you’ve seen over the last ten quarters remained constant at 6%. So we are not seeing any change.

John Murphy

Okay, great. Thank you very much.

James Hackett

Thank you, John.

Operator

And our next question is going to come from the line of Rod Lache, Wolfe Research.

Rod Lache

Hi, everybody.

James Hackett

Hi, Rod.

Rod Lache

Thanks for taking my question. I had a couple. Just on Q4, just to follow on John's question, North America, it equates a bit lower than expected in the quarter and I was wondering, is there an unusual warranty catch-up impact in there? How should we be thinking about warranty which is up a lot over the past few years, anything in there that shouldn't recur next year?

And then, also on pricing, I am still puzzled by what changed relative to incentives. Just thinking about the market, one of the biggest changes that's happened since your last call is that GM has had a strike and their in-transit pipeline is basically emptying out.

So, if anything with your biggest competitor declining to maybe 50 days of inventory, I would think that the pricing environment gets better from here. So it sounds like you disagree. I was hoping you can elaborate.

James Hackett

Thanks, Rod. This is like the Chicago thing. I just want to make it clear that the management team, starting with me understand that warranty is an opportunity for us to fix things that underlying challenges in our processes or the way we've done things. It's my early work that I got involved in, Rod, in fact, when we met in New York in our first gathering, I talked to you about this that we attack the product development process with a lot of vigor.

And you understand the gestation period in the auto industry. So a lot of the improvement that we have made, Jim Farley, Joe Hinrichs, myself, how tie tang in getting the portfolio to generate all the new products that we are talking about coming with less capital committed that we – that was planned when this new regime started $20 billion less.

I am confident that the work that the PD process is undertaking is going to generate better performance. However, with that said, Joe and I are committed to control of our business and we've been surprised ourselves by some of these things because these are, Joe will explain, products and service, some that are longer three and four years out that.

Of course, we have to deal for our customers with problems and we'll do that. There is also with the DPS 6 transmission, we made a decision as a team to remove any kind of questions from ongoing ownership of the vehicles beyond really first ownership that the company would stand by in the performance of the products.

So this is a big Ford commitment to make sure that no one was suffering through that product challenge. I feel really good from what the company can control that we got a handle on that.

So let me just summarize by saying warranty is getting a lot of attention and the first thing is that the PD process has been restructured in the smart redesign house work there was kind of leading the company. But the benefits of all that, or in the next-generation of products. So Joe, maybe you can comment like on these historical products, what we've learned.

Joseph Hinrichs

Yes, Rod, thanks. So, as you look at it, the bulk of the warranty cost increases are in North America. It's 2018 model year and before that are the model years where we've seen an increase in the higher time in service warranty claims than we had accrued for and have been planning for. That's largely driven by some power train actions.

Some of those suppliers some of them are own, as Jim suggested, we've done a lot of rework on our product development process to make sure we've learned from this. But we have to get this bubble work into our system that we are seeing is here. We are seeing really good progress in our 2019 model year vehicles at the same point in time including six months, nine months in service, those kind of things.

So, we feel really good about the progress we are making. But we have this 2018 model year and a few years before that and working its way through the system. The way our process works, of course, we accrue the forward models based on the experience we've been having.

And so, it takes a little while for that to work its way through the system. But that's what you are seeing. It is largely in North America from that perspective and that's what you see.

On U.S. incentives, I just want to go back to what I was saying before, first of all, we haven't seen a markedly different approach by any of our competitors in the marketplace recently. We will watch that very carefully of course. F-150 transaction prices are $3000 higher than the all new Ram and Silverado even though our truck is couple years older.

But we are watching, as I said, there are couple of segments where we saw some changes in the dynamics that we didn't plan for in the second half Ranger and Edge were two of them I was referring to. But I also said that, that we saw in the third quarter and we've also seen in October so far that market has been pretty disciplined to your point and we are watching that very carefully.

But a little bit of the – the bulk of the guidance change is really warranty-related, just want to be clear. Some of these other issues are also important, but the warranty that we are seeing that we have to address some 2018 model year and before is really the majority of what changed in North America.

Rod Lache

Could you just clarity what the charges for preexisting warranty that you are rolling through the numbers this year? And then, just my last question is, what signs should we be taking away looking at the international numbers and kind of thinking forward, obviously there is savings here in Europe, China and South America, but the volumes are down as well in those markets?

So, as you sort of look at what's happening here, any color on how we should be thinking about the trajectory of improvement from here as we think about next year, the positives on cost maybe higher compliance cost issues, that kind of things?

James Hackett

Yes, so, Rod, on the go-forward warranty, what I have – what Tim and Joe have done in the expectation for the year, they have given you that in terms of the way that years been projected. So we don't go out beyond that, of course, we have our normal reserve for warranty. But Tim, I am going to let you add any color that might help them a bit.

Tim Stone

Yes, it's exactly as you said, and from a warranty cost perspective just to be clear, we do expect warranty to be up year-over-year. And again it's a key driver of our change in guidance for the fourth quarter. As accruals, we go through every quarter of course, then accruals are appropriate and reflect the experience as we have seen as warranties today through that point of time.

James Hackett

And Joe, you might talk about the color in Asia.

Joseph Hinrichs

Yes, on the international markets, Rod, we've seen progress obviously this year in Europe and in China. I think the European team is really making a lot of progress on redesign work that's been in place now for quite some time.

I feel good about the progress we're making. South America, still in some pressure from what's going on in Argentina, but the South America business continues to make improvements as well in their restructuring. So both Europe and South America are really well on plan where we want them to be on the redesign efforts.

On China, our sales have not come up as fast as we were expecting them to in the second half of this year. Part of that's industry, but part of that's our own performance. We are really seeing the dealer network starting to really grow their sales force, their profitability is returning, so - and our inventory is in really good shape.

So we are watching that very carefully. I think the one to watch is, what's the China industry and how well do we do with our new models that we are launching in the third quarter, like the Focus Active, the Edge ST and ST line, the Taurus, the Territory EV and number of our products coming. We need to show growth in our China volume.

So, the volumes are down as you suggested. Part of that's intentional with some of the product changes we made, choices we made in Europe to gather some of that volumes and with the downsizing we are doing in Europe, we gather focus and – I am sorry, in South America, got our focus in Fiesta production.

That's by design. But I think hopefully, you'll see from here forward, we can grow the business in China with the products we have and you will see continued improvements in the European business.

Rod Lache

Okay. Thank you.

James Hackett

Thank you, Rod.

Operator

And our next question is going to come from the line of Joseph Spak, RBC Capital Markets.

James Hackett

Hi, Joe.

Joseph Spak

Hi, good afternoon. I guess, I want to turn back to North America and dive back into the Explorer a little bit. So, you mentioned wholesales in North America were down slightly. In the U.S., they were up slightly. I think that's pretty close to what you did from a production standpoint. So, I guess the real question is, were all those Explorers that we read about the challenges about wholesale this quarter?

Are there vehicles at Flat Rock, as has been reported? And even if they are at Flat, are they wholesaled? And I guess, if they were wholesale to set the dealers, if you are just still doing the rework on them, is that also some of the costs that might be considered in the fourth quarter?

James Hackett

So, Joe Hinrichs can clear this up. I am not happy with the press' view of way we work through this. I mean, I am just going to I think tickle your fancy a little bit by having you understand how diversified changes are in the auto industry. When products come from all kinds of trajectories in terms of what makes them up, there is no companies that are vertically integrated anymore.

So the way the reporter talked about how things are moved around and shifted as an indication that the process was broken, that's just not fair. And we were doing things because we were trying to take some of the pressure off this job per hour or JPH that Joe talked about. We could reduce some of the complexity.

So that's - that actually worked. So that was – that's the way that was painted as a negative. It was actually misrepresented and what he was saying to you is that the wholesales were still down 19,000 units, but that was worst last quarter. So we've made a lot of progress but Joe, I don't know if you want to add more to.

Joseph Hinrichs

Sure, so, Joe let me just be clear. We shipped about, through the end of the third quarter, it's just the data I am referring to, we shipped about 96,000 units. We had about 9500 as inventory. Most of those were in Chicago. There is a couple of thousand still in Flat Rock. Just a reminder, there is no physical space around the Chicago assembly plant.

So, when we have any issue, there is no place to put the vehicle. And if you ever been in the south side Chicago, you know there is no physical space. But some of the reports have been overly dramatized. We've used the Flat Rock for many launches, because we - you do this in the past because Flat Rock right now is working on one shift. It has plenty of capacity. It has lot of skilled depot.

It has a rail yard nearby and when you are doing software updates or even if you are doing some physical repairs to the vehicle or doing some inspection, having skilled depot and having floor space and space in the yard to be able to do that is much more important to be able to do that with a good quality than trying to force it, moving vehicles around, because you have no physical space.

And so, we think we’ll have all the inventory cleared up by the end of November. And we feel really good about that. We have plenty of inventory out in the field now for both Explorers and Aviators and the dealerships. A lot of that came on pretty quickly admittedly in the September and October, we’ve been shipping.

Actually, in the last week, we've shipped a little more than we actually built, because we are actually starting to clear out some of those units. So we are shipping what we are building right now and we feel really good about the flow of that going forward. But we just don’t – we don’t talk about it, but we’ve leveraged Flat Rock a number of times over the last five or six years on launches.

But unfortunately, the lost production that we had in the slower ramp up than we expected in Chicago led us people wanting to report on other things as well. So, our first and foremost approach, of course is attack the customers and keep them, yes, keep them well protected.

And I want to be clear about on your question, we don’t recognize the vehicles as wholesale and in our revenue stream until they are released with good quality and saleable to the dealer and to the customer. So, all those vehicles that I am telling you that are still on hold, they are not wholesaled. We don't wholesale until we are - they're gate released with the quality to be able to be sold.

James Hackett

In fact, that discipline is really important, because, if we lose one customer, can you imagine the future cash flow loss of losing a customer? So, it's better that we get this right. The other thing, Joe, is if you follow the transit business or the F-150 business, those have multiple factories.

So, when we're in the middle of launches with those vehicles, there is relief because of the way Joe Hinrichs can move things around. So, I am just echoing what he said to you, is Flat Rock was not evidence of chaos. It was evidence of us making sure things were right.

Joseph Spak

Okay. On the automotive free cash flow is still higher year-over-year I noticed in the quarter, the Ford Credit distribution was up and I think year-to-date now it's at $2.4 billion, which I think is only slightly below what you sort of kind of previously indicated for the year. So, within that guidance, are you raising the Ford Credit distribution for this year, because maybe the performance of Ford Credit is stronger?

And then while we're on cash flow, just maybe if you could provide an update on some of the cash with the redesigned cash flow, because again, that looks sort of light, the $1.5 billion to $2 billion you've indicated prior to this year, unless there is a big fourth quarter.

James Hackett

So, Tim, you can field this.

Tim Stone

You bet. This is Tim. So as it relates to Ford Credit, the cash distributions tend to track with profitability for Ford Credit and that's been consistent over time. So that will just be a natural flow. We haven't given specific Ford Credit cash flow guidance. But it’s certainly factored into our expectation that we'll have growth in free cash flow, and it's been part of the 80% growth we've seen year-to-date so far this year.

On the special items, the cash thus far in 2019 is in $0.7 billion and we had said in Q2 that we expected $1.5 billion to $2 billion of cash. We've had a deferral in that. Similarly, earlier in the year we expected $2 billion to $2.5 billion in cash. So we continue to refine our estimates of the cash ramifications from the restructuring actions that we're taking and I now expect $1 billion to $1.5 billion in 2019. Again, $0.7 billion of which has already occurred.

James Hackett

And that's…

Joseph Spak

Just to be clear on the Ford Credit distribution, I guess, versus what you thought after the second quarter, embedded in the Automotive free cash, is the distribution higher than prior?

James Hackett

Yes, we haven't given any specific commentary on when and how the flows occur. Again, they track with profitability over time.

Joseph Spak

Okay.

Operator

All right. Our next question is going to come from the line of Brian Johnson, Barclays.

Brian Johnson

Yes, good afternoon. So, a couple questions. First, vis-à-vis Ford Credit, since a lot of the other questions have been asked, I was a little bit surprised by the cut in - or the improvement in expected decline in auction values.

Given some softness we saw in Mannheim overall in the quarter, is there something specific to the kind of lease returns that you've been getting? Or, something that makes it a little bit better? And then, kind of as you kind of roll forward into next year, what's your expectation on that?

James Hackett

Yes, Brian, I'll turn that to David. But I have to smile, because I am really proud of the brand. So I do think the brand carries when you are talking about F-150 pickup trucks and things like that. But David, am I right about that?

David McClelland

Sorry. Thanks for the question. I think I touched on it a little earlier. So, we look at the performance year-to-date, which is down just short of 2% and then I looked at the performance last year, throughout the year and the trends actually over the last few years and then what happened last year in the fourth quarter.

And then, specifically and importantly look at the return mix, which is what Jim was getting at and if you look at the return mix, remember Mannheim is off a really historical mix.

James Hackett

Yes.

David McClelland

So if you look at our specific return mix, I feel comfortable that the 2% number is about right.

Brian Johnson

Okay, good. And he second question, as long as we are going into Ford Credit, there has been a lot of negativity in the press around extended loan terms, subprime, underwater trade-ins being rolled into the loan, which would imply poor loan to values. Can you comment A, just on the general industry trend there? And B, the Ford Credit specific approach to that?

James Hackett

Well, again, Jim Hackett. I am going to warrant to you, the way we run this company is what I'd like to talk about and there is a lot of integrity in the way we think about this balance sheet and the way we handle customers. I don't really want to comment on the others. There are practices that you would see that we would not accept at Ford Credit. David?

David McClelland

Sure. Yes, thanks. So that the - again, echoing what Jim said, not to talk about outside of Ford Credit, but I can talk with some confidence about the credit company itself. The business that we're putting on the books remains very strong where our FICO For the quarter is 750 and we're not moving at all on any of the higher risk business that we're doing.

And then, really to the heart of your question, we are not in the longer terms. We're not, even if the average transaction price is going up. We are not seeing any movement on our longer-term business, which the mix of that, the 84 month is only 3%.

There is nothing that I'm seeing in the performance in terms of delinquency, even the early, early defaults, non-delinquent defaults are not moving, 30, 60, 90s are fine. In our slides, there is a seasonality on the LTR, but that is simply seasonality.

Just look at 2Q18 versus 2Q19. Your prior questions about the disposals in terms of the residual values are pretty good. So, I mean we are staying diligent, but I am comfortable and confident that what you're reading about is not what you're seeing in the credit company.

Brian Johnson

Okay, thank you.

James Hackett

Thank you, Brian.

Operator

Our next question will come from the line of Adam Jonas, Morgan Stanley.

James Hackett

Hi, Adam.

Adam Jonas

Thanks, everybody. Hey, Jim, how are you?

James Hackett

Good.

Adam Jonas

Good. Just two quick questions and apologies for the background noise, just wanted to zone in on the consolidated China business, which my understanding is imported products, it is, I know, very Lincoln heavy from the U.S. into China, calculating an operating margin loss of around negative 25%, negative 30%, that territory. Can you just again justify or explain why would you do that?

I guess, it doesn't strike me as a business worth doing. Do you have a choice to just stop doing that? Just to stop selling U.S.-made cars into China, which, for a variety of reasons, as a global automaker, you think you've got to make where you sell. Is that something you can stop doing? Or is there a story of, you are trying to keep the blood in the patient, the dealer lifeline kind of going and that can kind of we can cycle out of that and stop doing that stuff?

James Hackett

Yes. Well, I think your analysis, as always, is really good and I mean, imagine together the way we ask Joe Hinrichs to plan with the tariff structure that is in, it's up, it's out, it's down. And so, I do think that I've been public and said a year ago when I asked about this, I thought there would be a resolution in the way that we'd have certainty and what I would say an equilibrium if you remember, that we could plan our business and Lincoln was responding really well to exports from here.

That is an example where there is blood in the patient, so to speak. The brand was growing as fast as anything in the country, and we've made commitments. People had made commitments to us. I thought where you were going was also about the larger question of participation in China, which is something I am still committed to. I think there is a formula there, a business model that Ford can excel at.

But Joe, I don't know if there is any more. You remember, Joe Hinrichs, who is now President of Automotive, also got us started in China. So he has had some, he was on the ground there and had experience. But the question Adam is asking, you know, of is there false – are we doing false things here that aren't sustainable?

Joseph Hinrichs

Yes. It's a very fair question, Adam. I recognize our consolidated operations in China are complicated, because we have the Lincoln imported products that, some of the Ford imported products. We also have the cost structure of Ford-owned entities and employees in China and then we have our allocations from the corporation and from engineering, et cetera, are in the consolidated numbers.

So it's a compilation of a lot of things. Suffice to say, we don't believe in exporting vehicles at a contribution margin loss, as long as we don't have a spike in import duties that are a near-term issue. The solution to this largely is around localization plans for our business in China. We've been very public about, we have five more vehicles being planned to be locally assembled in the near term.

That includes the Lincoln Corsair and the Ford Explorer. So a number of products are going to be localized over the next year, year-and-a-half, which will really influence this. It will help us be more competitive cost-wise in the business in China, but also will take away some of the exposure we've had, just some of the fluctuations in tariffs.

So, we feel good about that plan. As you know and you noted, the Lincoln plan has been an import plan until now, when we started localizing Lincoln Corsair and then more to come from there, which will really help with this. So they're contribution margin positive. There is a lot of costs in the consolidated business. But this will largely get taken care of by the localization plans we have going forward. Thanks.

Adam Jonas

Thanks, Joe and Jim, and if I can just sneak in one more on hybrids. There seems to be this referendum going on in global autos where some companies are kind of canceling their hybrid programs and saying very openly that they view them as kind of regulatory cars and kind of compliance vehicles that consumers don't really fully value, even if on paper they make sense and they are really complicated vehicles. And not a lot of capital to throw around. Others are moving straight to EVs.

And then some, I'd say like you and Toyota are in a camp of, hybrids are the real deal. They are going to be with us for a long, long time and consumers value them. Maybe Joe, for you, if I were to ask you kind of 5, 10 years out, you are in a long-term business where product you are planning now, some of it won't even be on sale for north of five years and it has to be on the road for 10 or 20 years.

If I put that longer-term hat on, are you equally bullish on hybrids as you are on EVs? If I force you to pick one, really that 10-plus years, where is the incremental Ford dollar going to invest?

Joseph Hinrichs

Yes, Adam. Thanks. There is a lot there. So, when Jim Farley announced, I think it was now a little more than a year-and-a-half ago about $11 billion commitment to electrification, we were all in on all parts of this discussion. Yes, we see significant growth in our hybrid business over the next five years and part of that is, we think that where consumers are today and where costs are today, that makes a lot of sense for the economic choice of the consumer.

As you know, we're taking a portfolio approach to this. It isn't just about hybrids or plug-in hybrids, it also about electric vehicles starting with a very exciting vehicle next year and the other ones are coming after that. So I think you are talking about a transition period. We think that hybrids will continue to be part of the equation for a number of years to come.

But our BEV portfolio will grow substantially over the course of time and we think that ultimately is where this largely goes. But we do see a role for hybrids in the portfolio.

Remember, we get questions all the time about, with the movement of sedans largely out of the North American portfolio, what happens if gas prices spike? Well, again, our portfolio approach, which we've been consistent all along, our new SUVs all have some kind of electrification as part of each nameplate we're launching, so that we can offer solutions to customers, if we should see a spike in fuel prices or other things.

So there is a number of reasons why it's important to us. But we are bullish on bad electric vehicles. We think it will be toward the end of the decade that will be a significant portion of the portfolio of electrification. But we do still see hybrids as being an important part of the portfolio, especially in the near term, where there is no compromise, no range anxiety for consumers.

James Hackett

In fact, Adam, I loved when we had this exchange a year or so ago, I was doing the thing where I would bring up the computer industry as a proxy and we were saying can you convert that to thinking about automotive? You remember when computing was – where we were moving from chip size, Pentium, et cetera, and you would buy the next-generation computer based on that.

And of course, that's been blown up in terms of the way the markets now respond to computing. You know, what Apple has done in terms of the iPhone. We see the features and virtues, rather than what's inside of it. I think this is going to happen now in automotive. I give Jim Farley and Joe a lot of credit here, as Ford was leading in this way.

In other words, all the rhetoric was around, do you have electric vehicles or do you have hybrid vehicles? And we've got this exciting thing coming in November that is going to take advantage.

Adam Jonas

I can't wait.

James Hackett

I know and what I want you to imagine with me is the dialogue is going to start to shift, because the nature of the product is going to be what's talked about rather than the propulsion. Of course, we're committed to that. We've got this F-Series coming and of course you know we've been working on a battery electric inside of that.

Imagine when the Bronco comes, how exciting talking about Ford products is. So, I just want to say that I love where you are going with the question, and I'm really excited about the way Ford is interpreting that.

Joseph Hinrichs

And just a reminder, as battery costs improve or lower, hybrids also become more affordable. It's not just about electric vehicles. So, that becomes also part of the equation for the customer.

Adam Jonas

As long as the internal combustion part of the hybrid does not increase, does not offset that. But I get your point, Joe and I do appreciate both of you on that - answering the question. Thank you.

James Hackett

Yes, thank you. And so, let me just close and say the third quarter results do have evidence of the global redesign of Ford. When you heard the news about how Europe persistently now is improving, and so it's driving these positive shifts. But, make no mistake, humility of the work that we still have to do, I am still very confident in the team here and the progress that Ford Motor Company is making.

We are focused on improving our fitness and our outcomes. This is driving a winning portfolio, where we're fortifying the strengths. As you heard me just mention a moment ago to Adam improving mix. And we're focused on laying groundwork to improve the trajectory of long-term growth in cash flow and profitability.

That evidence is really starting to show up in the previous calls. You all asked us, are you sure your structural costs aren't rising? You know, we really have attacked this and I think we have a good handle there. And then a commitment by me personally that things that you would expect us to do better, that we are addressing, and we are.

So thank you very much for your attention this evening.

Operator

Thank you. This does concludes the Ford Motor Company third quarter earnings conference call. Thank you for your participation and you may now disconnect.