Eaton Corporation (ETN) CEO Craig Arnold on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-29-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $1.52 beats by $0.01 | Revenue of $5.31B (-1.81% Y/Y) misses by $-199.95M

Earning Call Audio

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Eaton Corporation (NYSE:ETN) Q3 2019 Earnings Conference Call October 29, 2019 11:00 AM ET

Company Participants

Yan Jin - Senior Vice President, Investor Relations

Craig Arnold - Chairman and Chief Executive Officer

Richard Fearon - Vice Chairman, Chief Financial and Planning Officer

Conference Call Participants

Nigel Coe - Wolfe Research

Jeff Hammond - KeyBanc

Dave Raso - Evercore

Scott Davis - Melius

John Walsh - Credit Suisse

Nicole DeBlase - Deutsche Bank

Joe Ritchie - Goldman Sachs

Jeff Sprague - Vertical Research

Andrew Obin - Bank of America

Chris Glynn - Oppenheimer

Ann Duignan - JPMorgan

Julian Mitchell - Barclays

Rob McCarthy - Stephens

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Eaton Third Quarter Earnings Call. [Operator Instructions] I will turn the call now over to the Senior Vice President of Investor Relations, Mr. Yan Jin. Please go ahead sir.

Yan Jin

Good morning. I am Yan Jin, Eaton's Senior Vice President of Investor Relations. Thank you all for joining us for the Eaton third quarter 2019 earnings call. With me today are Craig Arnold, our Chairman and CEO and Rick Fearon, Vice Chairman, Chief Financial and Planning Officer. Our agenda today including opening remarks by Craig highlighting the company's performance in the third quarter. As we have done in our past calls, we will be taking questions at the end of the Craig's comments. The press release from our earnings announcement this morning and the presentation we will go through today have been posted on our website at www.eaton.com. Please note that both the press release and the presentation, includes reconciliations to the non-GAAP measures. A webcast of this call is accessible on our website and it will be available for replay.

Before we get started, I would like to remind you that our comments today including statements related to the expected future results of the company and are therefore forward-looking statements. Our actual results may differ materially from our forecasted projections due to a wide range of risks and uncertainties that are described in our earnings release and the presentation. They are also outlined in our related 8-K filing.

With that, I will turn it over to Craig.

Craig Arnold

Thanks, Yan. Appreciate it. And we will start on Page 3 with a highlight of our Q3 results. And overall, I would characterize this quarter's results as really strong earnings results and strong cash flow despite weaker end markets. Earnings per share as you saw in the press release were $1.44 on GAAP basis, a $1.52 excluding transaction costs and acquisition and divestiture in excess of our businesses, $1.52, our results were 6% above last year, excluding the 2018 arbitration decision and within our guidance range of $1.50 to $1.60. However, sales were certainly lower than what we expected, down 1% organically, negative currency impacting us by 1.5 points and acquisitions adding 0.5 point to our results.

We continue to deliver strong margin performance with another record and all-time earnings on margins. Segment operating margins of 18.7% for an all-time record for Eaton and this includes records for electrical products, for electrical systems and services, and for aerospace. These margins were also above the high-end of our guidance and 110 basis points above last year. We continue to generate very strong operating cash flows of $1.1 billion, up 8% over Q3 2018, an another quarterly record. Lastly with summarizing results where we purchased 539 million shares in the quarter bringing our year-to-date purchases to $949 million or 2.8% of our shares outstanding at the beginning of the year.

Turning to Page 4, we show a summary of our Q3 performance versus prior year and I will just point out a few highlights here. First, we delivered $41 million of increase in segment operating profits despite a 1% decline in organic revenue and this was really driven by strong execution, effective cost control and favorable mix in a couple of our businesses. Second, we incurred $0.08 per share of after-tax cost primarily related to the planned divestiture of our lighting business. And lastly, adjusted EPS increased 6% excluding the

2018 arbitration decision. These results I would say are consistent with our boarder message on how we intend to run the company doing periods of market weakness, with strong execution, proactive cost control and increasing our share repurchases.

On Page 5, we show our quarterly results for our Electrical Products segment. Overall revenues were flat made up of 1% organic growth offset by 1% negative currency. We saw revenue strength in both commercial and residential markets in North America partially offset by softness in industrial controls globally. Segment operating profits increased 6% and operating margins were up 110 basis points to 20.3%, which was an all-time record for the segment. We also announced the sale of our lighting business to signify for a price of $1.4 billion and we have seen a good outcome for our shareholders and another example of how we are actively managing the portfolio to create higher margin and higher growth set of businesses for Eaton. This was a decision that was also good for our employees who will now be part of a larger and more focused lighting company. The transaction is expected to close in the first quarter of 2020 and I would say for our core products business which now excludes the lighting, orders were up 1% led by strength in residential and commercial construction largely once again in the Americas.

Moving to Page 6, we summarize our results for our Electrical Systems and Services segment. Revenues increased 3%, 3% organic growth. We also had a 1.5% growth from the acquisitions of Ulusoy and Innovative Switchgear Solutions and a 1.5% of negative currency. Organic growth here was driven by strength in data centers, commercial construction and actually also in engineering services. Our ES&S business also produced all-time record margins of 18.3%, which were up 290 basis points from prior year, operating profits increasing some 23% on 3% organic growth. This business benefited from higher sales for sure, but also had very good operational execution in conversion. And on a rolling 12-month basis, ES&S orders were up 5% with growth really across I would say all regions here. And if you exclude hyperscale data centers, the 12-month rolling average of our orders was up 8% which was really in line with what we saw in Q2. So once again, a long cycle business very much performing at very high levels.

On the next page, we show our results for Hydraulics for Q3. Revenues were down 10% with an 8% decline in organic revenues and 2% negative currency. Organic revenue declines were driven primarily by weakness in global mobile equipment markets and in quite frankly de-stocking that we have seen both at the OEM level and also within distribution. Segment operating margins were 11.9%, down 290 basis from last year but I think on a sequential basis, margins were actually up 40 basis points despite seasonally lower Q3 revenues that came in about $100 million below Q2. And our order declined to 14% really as a result of continued weakness, as we mentioned in global mobile equipment markets around the world.

Turning to Page 8, we summarized our quarterly results for Aerospace segment. Once again, this business posted very strong results with record top line and bottom line performance. Revenues increased 7% with 8% organic growth and 1% negative currency. Orders on a rolling 12-month basis increased 13% with particular strength in the military market, specifically for fighters, for watercraft and also aftermarket. We also saw strength on the commercial side in business jets. We continue to demonstrate strong incremental margins with nearly 60% growth in margins on organic revenues which drove over 23% increase in operating profits and a 310 basis point improvement in our margins. And as you recall, we announced the acquisition of Souriau-Sunbank in July and we expect this transaction to close before the end of the year, so all things are good in aerospace.

On the next page, we summarize our Q3 results for the Vehicle segment. Our revenues were down 13% which includes a 12% decline in organic revenues and a negative 1% impact from currency. The organic sales decline was due to a combination of global weakness in light vehicle markets which we think were down approximately 4% in the quarter and primarily the impact of the transfer revenues into the Eaton Cummins joint venture. For 2019, the NAFTA Class 8 market remains solid. We expect production to be roughly 340,000 units this year and up 5% for 2018. We do however expect global light vehicle market to be down some 4% for the year. Despite lower organic revenues and volume, operating margins continue to run at very high level at 18.3%, margins were down only 60 basis points from last year. So our vehicle team once again did a nice job of flexing spending which allow them to deliver detrimental margins of approximately 25%.

Moving to Page 10, we show our eMobility results for Q3. Revenues were down 1% with flat organic revenues and negative 1% from currency. Flat organic revenues in this case of due primarily to a mix of platforms that we're on, I'd ask you to keep in mind that in this business is really made up of a mix of the new electric and hybrid platforms plus the legacy electrical content that we have on internal combustion engines. Once again, we increased our R&D spending which was really the primary reason why operating margins declined 740 basis points to 5.1%, but we continue to pursue a large number of additional electric and hybrid programs here and we are very pleased with the progress that we are making to-date.

Next on Page 10, we summarized our outlook for 2019. We now expect organic revenue growth of approximately 1% and as you know this is down from our prior estimate of approximately 3% and this is really based upon reduced global growth, particularly in our short cycle businesses but also includes some slow growth in non-res construction as well, still growth but slower growth which has impacted our electrical business. Within electrical, we now expect full-year organic growth of approximately 2.5% for electrical products and 4.5% for electrical systems and services. Hydraulics global mobile equipment markets remain weak and this weakness is being amplified, but really de-stocking in both the OEM and distribution channel. As a result, we now expect organic revenues to decline by approximately 4.5%. Aerospace remained strong across the board and we’re reaffirming the midpoint of our full year growth estimate of 9.5%. In Vehicle, global automotive markets remain weak so we’re reducing our organic revenue estimates to be down approximately 10% for the year. And we’ve also slightly modified our estimates for e-mobility as well which we think will be growth of 4% at the midpoint of 2019.

Overall, our long cycle businesses within ES&S and aerospace are expected to continue to deliver attractive organic growth rates for the year, while we project low single-digit growth for electrical products overall. Business conditions have clearly been impacted by trade, by the political environment and a number of one-off events that have weakened our second half outlook, maybe as a kind of confidence as we look to the future, we would say, what the fundamentals of the economy still solid, low interest rates. High employment, strong consumer confidence and we hope that is pulled back would be short-lived but we have to wait and see.

Moving to Page 12, we show our margin expectations for the year and I think based upon the strong Q3 margins we are increasing our consolidated segment operating profit margin guidance 20 basis points to a new range of 17.3% to 17.7% or 17.5% at the midpoint and this includes increasing margins for three of our six segments, Electrical

Products up by 30 basis points, Electrical Systems and services up by 50 basis points and Aerospace up by 120 basis points. And due to expected volume declines we are lowering margins in two of our segments: hydraulics by 110 basis points and vehicle by 40 basis points. With this updated guidance, I would say that we are really on track to deliver another record year of margins with a strong 70 basis point increase at the midpoint over 2018 despite lower revenues can we anticipated.

And finally turning to Page 13, we show our guidance for Q4 in 2019. For Q4, we expect adjusted earnings per share of $1.36 to $1.46, other assumptions for Q4 in our guidance include, we think our organic revenues will decline by approximately 2%, we would expect segment margins of 17.2% to 17.6%, flat corporate expenses of two last year and an adjusted earnings tax rate of approximately 17% we are slightly lowering the midpoint of our full year 2019 adjusted earnings per share guidance to $5.72, $0.09 below the current consensus and due to lower market conditions. This does still represent a 6% increase over 2018 when you exclude the impact of the arbitration decisions. We are also increasing our operating cash flow guidance by an another $100 million as you recall that we increased it by $200 million so far through this point and we now expect to deliver $3.4 billion to $3.6 billion for the year, because I mentioned the second time that we will increase our operating cash flow guidance which highlight really the strong cash flow generation capability of our businesses. For 2019, our free cash flow to adjusted earnings conversion is expected to be over 120%, while free cash flow to sales is estimated to reach approximately 14%.

Other full year guidance assumptions include 1% organic growth, a $100 million of revenue from the acquisitions of Ulusoy and Innovative Switchgear Solutions, foreign exchange impact of a negative $350 million and this is actually $50 million worse than our prior guidance, segment margins in the range of 17.3% to 17.7%, up 20 basis points at the midpoint. No change in our tax rate, we think our CapEx spending this year will be roughly $550 million and this is about $50 million lower than prior guidance and we estimate for our share purchases to be increased to roughly $1 billion and this is up from our prior guidance of $800 million as we continue to deploy our strong free cash flow. So overall, we are very pleased with the company's performance this year. We are delivering very strong cash flow, solid EPS growth despite what turned out to be a much weaker economic environment for many of our end markets.

So I will stop with that and turn it back over to Yan for Q&A.

Yan Jin

Thanks, Craig. Before we begin the Q&A session for our call today, I do see we have a lot of individuals have interested in the queue with questions. Given the time constraint of one hour today and our desire to go to as many of the questions as possible, please limit your opportunity to just to one question and a follow-up. And I will thank you in the advance for your cooperation.

With that, I will turn it over to the operator to give you guys the instructions.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] Okay. We will take the first question from Nigel Coe with Wolfe Research.

Nigel Coe

Thanks. Good morning.

Craig Arnold

Good morning, Nigel.

Nigel Coe

Obviously lot of good detail on the call, you did a great job of adjusting to the trending conditions in 3Q showed us a very nice margin, you are assuming margin step down a bit more than normal seasonality in the 4Q. I'm just wondering what's driving that Craig I recon, is there any additional restructuring coming through in 4Q and where we stand on additional restructuring actions in lights of that weaker volumes?

Yan Jin

I appreciate the question, Nigel. I mean to your statement, absolutely, if you think about kind of the bridge between Q3 and Q2, we're really outstanding performance in Q3 there were number of items that were impacting us in Q3 and Q4 that are taking the margins down, one is a higher level of restructuring and you could imagine, it's largely in those businesses where we're seeing additional market weakness. We certainly are seeing a higher tax rate in Q4 than we had in Q3 if you saw the operational tax rate of roughly 17%. In addition to that there is a few normal factors, healthcare cost tend to run higher in Q4 than in prior quarters. And so this is a number of, one-time items that we are dealing with in Q4. Obviously, we dealing with the GM strike that a little bit of an impact as well in Q4 that take the margins down, but I'd say that as you think about the outlook for 2020, I feel a lot of these are one-time items and I know that a number of the analysts wrote about extrapolating Q4 into next year, I guess I just ask you to keep in mind that there are a number of one-time and seasonal items that are impacting Q4 that you really would not be justified and extrapolating for the full year.

Nigel Coe

That's great color. We will dig into the details offline but I do want to switch to ESS margins and we probably 2 years ago thinking 15% and this business will be a dream and here at 18%. So I am just curious how confident we feel that you can defend this level of margin going forward and maybe just address what's changed to drive such a high margin?

Craig Arnold

Once again we agree, 18% is outstanding performance by our team in general. And as I mentioned in my commentary, it is a function of really strong execution by the organization on higher volumes that we saw in the quarter and we will clearly need to revisit the long-term margin guidance for our ES&S segment. If you recall, we talked about this segment performing at 13% to 16% through the cycle, we're already performing well above those numbers and so as we think about giving the outlook for the business and setting expectations, we do believe that this business will perform at higher levels on a go-forward basis.

Nigel Coe

Thanks, Craig.

Yan Jin

Okay, good. Our next question comes from Jeff Hammond with KeyBanc.

Jeff Hammond

Good morning, guys.

Craig Arnold

Good morning, Jeff.

Jeff Hammond

If you can just talk about kind of where we stand in the de-stocking for Hydraulics? And then just are you seeing any de-stocking in electrical and maybe just speak through where in the guide you are seeing softness within, I guess particularly EPG?

Craig Arnold

Yes. I think in terms of Hydraulics, as we talked about on our commentary, we have seen broad-based de-stocking significant, let's say, de-stocking at the OEM channel as productions continues to run well below retail sales and you see that in a lot of the public data in also in distribution we are seeing the same thing. I think the question becomes how long does this go on and that we could sit here and attempt to speculate when does the de-stocking and it's really going to be a function of what ultimately happens with the end-markets and it's indicated in the end-market demand. I will say that today we take a little confidence in the fact that the end market demand in many of these hydraulic markets around the world are certainly performing okay. We are talking about, let's say, on average low single-digit growth in a market like construction flat to slightly down in markets like ag, but what we are experiencing as a supplier is our numbers at a much worse than that. So we take some confidence in that that we are approaching the end, but I think ultimately it will really be a function of what's going to happen with these end markets in terms of de-stocking in hydraulics business. I would say in the electrical business more broadly, at this point we are not really seeing significant de-stocking in electrical and what kind of impacted our growth a little bit in electrical in the quarter was largely project delays given the kind of the uncertain political environment that we are living in right now. It's been really more of that issue than it's been an issue of de-stocking. And certainly if you think about our Electrical Products business much of which goes through distribution in periods of uncertainty, they are kind of being cautious around the inventory levels that they are putting on the shelf in general, but not at this point I would say a significant amount of de-stocking.

Jeff Hammond

Okay, great. And then Craig I think in past years you provide kind of initial views on out-year in third quarter and I didn't see anything in there? Anything you can give on kind of how you are thinking about the markets, incrementals and non-operating items and kind of uses of cash around the lighting sales? Thanks.

Craig Arnold

Yes, Jeff, your observation is absolutely accurate, Jeff. We would typically in this call give kind of some insight into 2020 given the level of uncertainty in the environment that we are currently dealing with whether it's trade or geopolitical or some of these one-off customer events. We thought it would be prudent at this juncture not to provide guidance for 2020 some of the Q4 play through and that we would then be providing guidance as a part of our earnings call in January. And so that's kind of the way we are thinking about that. The specific question around uses of cash, obviously we sold the lighting business – we will sell the lighting business for $1.4 billion and it would be our intention to use those proceeds to buyback shares. We are going to attempt to be smart and strategic in the timing of the buyback program, but the intention would be to use those proceeds plus our very strong cash flow generating capabilities to make sure that we fully offset any dilution associated with the divestiture of lighting.

Jeff Hammond

Okay. Thanks, Craig.

Operator

Our next question comes from Dave Raso with Evercore.

Dave Raso

Good morning. Apologize, I missed the very beginning of the call, but for the electrical businesses exiting 2019 into ‘20, the lighting business is still officially in the guide for fourth quarter for EP, correct, just to be clear?

Craig Arnold

Yes, yes.

Dave Raso

Okay. So, the orders were up 1% ex-lighting for ET and in ES&S orders. I’d say overall we’re probably a little better than people feared but can you help us understand, what you’re seeing beyond the quarter in the sense of, what’s in the back half, further visibility, short the normal, just trying to get a sense of Electrical start the year healthy because obviously people are wondering can we get the more cyclical businesses bottoming out at some point in the first half and hope they are all growing together in the end of the year?

Craig Arnold

I appreciate the question, Dave. The business that obviously we have the greatest visibility within our Electrical Systems and Services business and I will say that our order input in Q3 was quite strong across the board. Most of the end markets that we serve, I’d say posted anywhere from mid to high single-digit order growth in the quarter which really bodes well I’d say for the long cycle piece of our business with Electrical Systems and Services into 2020, I think it’s too early to make a call on it and that’s one of the reasons why we are not providing guidance, but certainly if we take a look at the order book and what happened during the course of Q3 in Electrical Systems and Services, we feel very good about the order intake and how the 2020 is shaping up and Electrical Products which tend to be much more of a book-and-bill business and as we mentioned, we did see a little bit of conservatism on the part of distribution, and in that business it just doesn’t tend to be a longer cycle business and so we'll just have to see what happens with some of these other kind of world events and what level of distribution confidence we're taking in with us into 2020.

Dave Raso

And the ex-Lighting in the fourth quarter or I should say it another way is lighting down in the fourth quarter, so I assume that will be out of the business when we give the guide in January [indiscernible] core business?

Craig Arnold

What I'd say is I appreciate the question, Dave, given the fact that we have entered into a transaction we signed, we prefer not to comment on lighting as it's going to ultimately be somebody else's business on a go-forward basis. And so as we think about lighting on a go-forward basis and we would prefer not to comment on that business given the transactions and the fact that ultimately somebody else is going to own it.

Dave Raso

I can appreciate that. Okay, thank you.

Yan Jin

Our next question comes from Scott Davis with Melius.

Scott Davis

Hi. Good morning guys.

Yan Jin

Hi.

Scott Davis

Craig, just to kind of address the elephant in the room when you have quarters like this, where you missed your guidance on the top line which doesn't happen to this extreme very often, does it make you kind of rethink the portfolio a little bit? I mean you got Hydraulics and vehicle that will actually goes around every cycle and is it worth the headaches? I mean I'll just leave it at that.

Craig Arnold

I appreciate the question, Scott. And as we have talked on this call before we would like to I'd say laid out our criteria for businesses that we like and the conditions under which we think we are going to stay in business and the conditions in which we're going to step out and I will say that if you take a look at our track record over time Eaton has done a lot of work around the portfolio and the lighting divestiture is the latest example of that. At the end of the day, you think about today hydraulics and the quarter delivered 7% of our company profit facility, at the end of the day whether Hydraulics grows 5% or shrinks 5%, it really doesn't have a significant impact on the ultimate earnings of our company. So we like to think that we're getting some of the execution issues behind us and it is a cyclical business, it will always be a cyclical business, but at the end of the day what really drives Eaton, as we said on the earnings call 80% of our earnings come from electrical systems and services electrical products in aerospace and that's really what drives the company. And we will continue to work on our internal plans to improve the execution of Hydraulics, they know what they need to do in order to continue to deliver and be a value creating part of the company. So I would say at this point we are comfortable with the portfolio and at the end of day will continue to focus on the things that we can control and side of the business, recognizing it these will always be cyclical businesses.

Scott Davis

Fair enough, Craig. And just as a follow-up, I mean I know you mentioned that you have got this billion dollars coming in and you are going to do more buybacks, but is this types of environment or you want to take another more aggressive look at M&A or is this the type of environment or it's so uncertain that it's better to push it to the right there?

Craig Arnold

We always look at the trade-off. We have been very disciplined over the years around in terms of understanding what our cost of capital is and we think it's roughly 8% to 9%, and we would expect the return order of magnitude to 200 to 300 basis points over, our cost of capital as a minimum. And so we have been very disciplined buyer through both at a low point in the economic cycle and we would continue to maintain that and that's the way we'll run the company. And so for us, it's always going to be a matter of trading off what an acquisition would do for the company in both strategically and in terms of EPS versus the option that we have of buying back shares at very attractive prices.

Scott Davis

Okay, good enough. Thanks. Good luck, guys.

Craig Arnold

Thank you.

Yan Jin

Our next question comes from John Walsh with Credit Suisse.

John Walsh

I wanted to go back to the Aerospace margins, obviously very strong. I know a couple of quarters ago, we had a conversation around OE versus aftermarket mix but similar to that ESS line of questioning, we are above kind of your through the cycle look on that business, how do you view the sustainability of those really strong Aerospace margins?

Craig Arnold

I appreciate the question and I'd say as I've said on prior calls, this is really been a little bit of a Goldilocks period for the Aerospace industry overall because you have really strong market demand, you have a very strong aftermarket and you have relatively by historical standards low program spending. And so you're seeing the result of that deliver very strong margins but that is certainly another one of the segments that we're going to clearly have to take a look at as we provide once again our longer-term outlook for the business in terms of what margin should look like through the cycle. And clearly that's one that will be revisiting and will likely go up, given the levels of the business is performing at today. But I'd say today when we think about whether or not 25% margins are pretty extraordinary and the business probably won't perform at that level every quarter but I will say that we're very comfortable today that the margins in this business will perform at very high levels and very attractive levels for some time to come and primarily because consumers are continuing to get on planes and that drives the aftermarket. The military business is really just kicking into gear right now and and Boeing and Airbus are sitting on very large backlog and so we think this business will be good for a very long time.

John Walsh

Great, thank you for that. And then obviously there has been a lot of questions around capital allocation addition In the strong cash, it's going to be coming in the door. I know you don't want to get ahead of yourself for next year but you've historically had this expectation to take down 1% to 2% of float next year. I mean, should we assume that the high end of, that's kind of where we should be base casing it?

Richard Fearon

Yes, it's. Rick, I would think of it this way, Our expectation would be take down 1% to 2% float and then the proceeds from Lighting on top of that, so you'll end up with considerably more than 1% to 2%.

John Walsh

Great, thank you for that.

Craig Arnold

And this is an important point because one of the things that we committed to you and the investor community in general is that as we think about how we would manage the company during periods of market weakness is that we said that we would use our strong cash flow generation capabilities in our balance sheet to essentially buyback shares to help offset pressures in terms of EPS and that's clearly what we did in Q3. And you could expect that as we look into 2020 depending upon where markets end up, that will continue to kind of run the same play.

John Walsh

Great thank you.

Yan Jin

Our next question comes from Nicole DeBlase with Deutsche Bank.

Nicole DeBlase

Yes, Thanks. Good morning guys. And maybe just the first question around the increase in the operating cash flow guidance, I guess, key drivers of the that it looks like the receivables balance is down inventories up a little bit, so just trying to reconcile where that's coming from?

Richard Fearon

You're right. Working capital was very strong. If you look at the combination of receivables and payables, the change from Q2 to Q3, you're just shy of $200 million and so we have done a good job all year at managing working capital, we expect that to continue into Q4 and already our initial thinking about next year would have further improvements as a variety of programs relating to for example correcting any billing inaccuracies that makes a big difference on receivables, but also in payables and making sure that we are paying our suppliers in a commercially reasonable time-frame and we believe we have further opportunities to improve both receivables and payables.

Craig Arnold

And to your point, Nicole, inventory is actually are up slightly. When you're facing into an economic downturn, we typically take inventories out of the organization so we quite frankly have a big opportunity still on in front of us in terms of really reducing our overall inventory levels and so to Rick's point we would expect 2020 to be another year of very strong cash flow.

Nicole DeBlase

Thanks, Craig. You actually just pre-answered my second question any thoughts on the monthly progression of organic growth throughout the quarter? Things are getting a lot worse for you guys in September and then I guess anything initial that you have to say on October relative to the guidance that you've provided today for the fourth quarter?

Craig Arnold

One of the thing that was out at the Investor Conference Nicole and Laguna, and it's been kind of indicated there that we have already seen really in the first couple of months of the quarter, some market weakness, which really I'd say persisted throughout the quarter. So if I say no, not particularly, September wasn't particularly weaker month than the other two months in the quarter in terms of the progression and how it unfolds. And in terms of October, I'd say, what we've seen so far is largely consistent with the forecast that we have provided.

Nicole DeBlase

Thanks. I will pass it on.

Craig Arnold

Thank you.

Yan Jin

Our next question comes from Joe Ritchie with Goldman Sachs.

Joe Ritchie

Thanks. Good morning guys.

Craig Arnold

Good morning, Joe.

Joe Ritchie

So, Craig, I wanted to touch on the just the disconnect between what you're seeing on the order growth side on ESS and what you're expecting from a growth perspective and you mentioned in your prepared comments project deferrals and so I'd love to get a little bit more color on where you're actually seeing project deferrals and how that kind of plays out into 2020?

Craig Arnold

Yes. And what you referred to as a disconnect I would say largely, if you think about the Electrical Systems and Services business, it does tend to be a longer cycle business. And probably the best proxy for what we would expect for that business in fourth quarter probably would have been orders that we have received in Q2 of 2019 and if you recall, we had a relatively weak order intake in Q2. So there is a time lag to that business but once again to your point, we did see very strong orders in Q3 and we think that does bode well for 2020. And so that's really the way I would think about that. And in the second half of your question was with regard to the…

Joe Ritchie

Just basically, how that played out for 2020. And I guess if I were to kind of ask a clarifying question, are you seeing any cancellations in your orders at all or is it just, really just deferrals at this point.

Craig Arnold

Mostly deferrals as it is always the odd ball cancellation that you would do it always see in these businesses but I'd say nothing that's increased significantly. Mostly, it's really delays.

Joe Ritchie

Okay. And then…

Richard Fearon

That's particularly true on the larger industrial projects.

Joe Ritchie

Okay, got it. Thanks, Rick. I guess my one follow-up and somebody asked this earlier, but I wanted to see if we can get some type of quantification. On the aero margins, what's the expectation for R&D stepping down both this year and then into 2020?

Craig Arnold

I think with respect to R&D, we've already seen the step down in R&D that's currently reflected in our businesses. And so today, I'd say we're probably running with respect to R&D as a percentage of revenue, we are probably running right now at historically low levels, primarily a function once again of new platform development from our customers, both on the commercial and the military side and so I would not expect an additional step down in R&D spending. It's really already reflected in the businesses run rate today in our earnings today.

Joe Ritchie

Okay, got it. Thank you, guys.

Yan Jin

Our next question comes from Jeff Sprague with Vertical Research.

Jeff Sprague

Thank you. Good morning, everyone.

Craig Arnold

Good morning, Jeff.

Jeff Sprague

Just a question on restructuring and I'll wrap it around lighting, a little bit, can you just elaborate a little bit on what you're doing on the restructuring front? Maybe help us think about how much additional there is in Q4 and is there kind of a stranded cost element with lighting that we should be thinking about?

Craig Arnold

I'd say that if you think about the incremental restructuring in Q4. I mean, order magnitude, Jeff, we're talking about a couple of $0.02 to $0.03 or so in Q4 from where we've been and I think the source of that question is what do you do with the stranded cost, You sell a $1.7 billion business obviously there is some stranded costs associated with that and we would fully expect to deal with all of the stranded cost. And so we will obviously in the context of the overall restructuring number that we put up and the cost of the ex that we talked about a $200 million of costs associated with the exit of Lighting embedded in that number was cost to deal with stranded costs, both at the corporate level and also inside of Electrical Products. And so we would expect to fully deal with our stranded costs inside of the business.

Jeff Sprague

Could you also elaborate a little bit, and I don't know if you need to pull it apart EP versus ESS but just kind of the trajectory of price in your business. And then just kind of the price cost algorithm looking into Q4 in the early part of next year.

Craig Arnold

Yes, what we have always said around price cost is that we are net neutral and that's really today I'd say where we ultimately will end up. I think we're slightly positive in Q3, just slightly positive but we would expect once again on a go forward basis that commodity cost inflation tariff driven cost increases that the company will fully offset that and we'll do a better job of making sure that we're getting price at the same moment that we're experiencing the cost but we really expect it to be net neutral to Eaton overall.

Jeff Sprague

Alright. Thank you.

Yan Jin

Our next question comes from Andrew Obin with Bank of America.

Andrew Obin

Hi, guys. How are you?

Craig Arnold

Good.

Andrew Obin

Just great execution. Question on Hydraulics as we think about production cuts at Cat and Deere, when do those get incorporated into your revenues, are we seeing some of them in Q3 or is that something we're going to see in queue? When do we see the bulk of it, that's what…

Craig Arnold

I appreciate the question Andrew as well, because it's what we've been dealing. We typically would run about 90 days in front of our customers in terms of whatever they're forecasting in Q4, we would have experienced in Q3 just given the lead time all the way back to the supply chain on many of the components that were sourcing and this is typical, by the way, if you take a look at this business over time, we typically see an outsize impact both on the way up and on the way down, when our big OEM customers go through these periods of a market correction.

Andrew Obin

Got it. And then the question in terms of shortfall, I know there was a quote from you that you were expecting 3% you got 1% and I know you gave it to us by end markets but can you just give a big geography buckets which one disappointed the most and that is obvious. I mean…

Craig Arnold

Sure. And I'd say that, in terms of end market specifically, it really was a down shifting in the growth rate let's say, the biggest market for us is always the U.S. market and I would say…

Andrew Obin

Yes, that's what I was referring to. Yes.

Craig Arnold

Still positive growth for sure across the board but certainly we saw a downshifting in the rate of growth in the Americas, we saw it in our Electrical Systems and Services business in large projects we saw in the distribution channel and Electrical Products. We saw a downshifting and growth in the oil and gas space, specifically in our Crouse-Hinds business.

Andrew Obin

Okay, thank you.

Yan Jin

Our next question comes from Chris Glynn with Oppenheimer.

Chris Glynn

Thank you. Good morning. So on Hydraulics with the restructuring kind of back-tail and a little more in the fourth quarter, and some comments about moving past inefficiencies, just wondering can you raise margins a little on, you are moderately down revs next year and the 13% kind of the bottom of your through the cycle range. Do you see that is being attainable?

Craig Arnold

I appreciate the question and the goal that we set for this business 13% at the bottom of the cycle, we think it's absolutely the right goal for the business and we think it's certainly attainable. I think the real question becomes where do these markets ultimately bottom out at but I think it would not be an unreasonable expectation that the business deliver, 13% margin at the level of economic activity that we're seeing right now in the business.

Chris Glynn

Okay, thanks. And then a bookkeeping one, any early kind of notional comments on the corporate guidance for next year, should we just leave it comparable?

Richard Fearon

We have got to work through our planning. As a general matter, we have been quite successful at holding our corporate costs flat year-to-year. And then down years taking it down a little bit. So that will give you some color.

Chris Glynn

Perfect. Thank you.

Yan Jin

Our next question comes from Ann Duignan with JPMorgan.

Ann Duignan

Thank you. Most of my questions have been answered. If I look at ESS, the Momentum Index has been weak all year, up a little bit in September but that reflects new projects being considered and should be a good leading indicator for ESS for next year. Where is the disconnect because they are seeing is it may be not momentum index, but you're seeing the actual Dodge Data improves and that's subscribing current orders?

Craig Arnold

I appreciate the question and because we spent a lot of time obviously internally trying to figure this one out as well. It is a long-cycle business playing across a very wide set of end markets. And I'd say that a lot of the macro data to your point and what we saw certainly in our own order book in Q3 was quite positive and with orders up 5% on a rolling 12% and 8% excluding data centers, those are pretty strong numbers. And I'd say you can always find in this business that in any given quarter, you could end up with numbers that vary from the kind of the longer-term or medium-term growth rates. And I think what we experienced in Q3 as we indicated was this largely a pull back, a large projects and some project delays and a bit of slowdown on oil and gas, but certainly what we've seen in Q3 and what we see in most of the macro indicators for this business, non-res construction continues to do well across the world. I mean, a little bit of moderation in the growth rates but still growth. And so, we remain optimistic about the prospects for this business.

Ann Duignan

Okay. I appreciate the color. And then just a follow-up on e-mobility, you normally report mature year revenue win but that business has accomplished. Could you update us on that?

Craig Arnold

In this quarter and I say we haven't had any new material wins in the quarter. So what we try to do in this business as you know these wins come in large chunks and as we get large material wins we will be sure to update you on how we're doing. But by and large we continue to be very optimistic. The business as we reported historically we are ahead of the schedule that we originally set out for the business and we're still extremely confident in our ability to create a $2 billion to $4 billion new segment for the company.

Ann Duignan

Okay. And I have from the last quarter that you're material revenue wins were about 390 million, is that still what I should think about?

Craig Arnold

Yes I mean they would have moved up slightly from that end but we'll try to get report, material wins, when the number moves in a material way, we'll give you an update.

Ann Duignan

Okay, I appreciate that. That's it from me. Thank you.

Craig Arnold

Thank you.

Yan Jin

Our next question comes from Julian Mitchell with Barclays.

Julian Mitchell

Hi, good morning.

Craig Arnold

Hi, Julian.

Julian Mitchell

May be just a first question around these ESS incrementals, very, very good performance, just wanted to make sure that there was nothing particular you saw around mix or something as a tailwind that you think would fade, what do you think this is just normal course of business and reflect sort of good project discipline?

Craig Arnold

I'd say that we obviously took a strong look ourselves that this business because the margins at 18.3% are very, very high and above our own expectations. And no, we did not see favorable mix in the quarter when we look at that issue specifically and it wasn't mix it really was largely this strong execution in the quarter. And I mean obviously there is always a mix of projects in any given quarter in ES&S.but no there was no particular unusual of one-time events that drove the performance.

Julian Mitchell

Thank you. That's helpful. And then secondly maybe switching to Electrical Products, you do have some reasonably large industrial and industrial controls exposure within EP, particularly now that Lighting is coming out? Maybe talk about that more industrial piece of EP, how you saw demand trends there in recent months and if you expect in Q4 demand in that industrial piece of EP to be any different in Q4 than Q3?

Craig Arnold

We appreciate the question, without a doubt, that the weakest piece of the business today, year-to-date and what we're forecasting is really what's going on in industrial markets in the manufacturing sector. And we generally talk about that being about a third of the business itself. And so it's a big material segment for us and we clearly have continued to see weakness in the industrial controls part of the business.

Richard Fearon

And then that was true Julian both on sales and orders in the third quarter.

Julian Mitchell

Great, thank you very much.

Yan Jin

Our next question comes from Rob McCarthy with Stephens.

Rob McCarthy

Hi, Rob McCarthy here. I guess the first question I would have is, and thinking about the sale Lighting, I mean I think it was 7.5 times trailing, it was certainly less than that on a forward basis. Horseshoes and hand grenades paid between 11x and 12x for Cooper, even if that was like, I had a company average. I mean, yes, we will be good to have of maturity of what you're talking about. But this is an exactly value creating into you are buying assets 12x and then at 7.5x trailing call it 7 or 8 years later. So, I mean do you think that this kind of activity kind of the, why the fact that perhaps we should look they can look at a part of what we had breaking up the company?

Richard Fearon

Well, Rob, let me just address that. I don't think your perspective is exactly correct, I mean do you have an idea the Lighting business when we bought Cooper. It was just under $1.2 billion and now at $1.7 billion, so we've grown the business quite significantly over the time period. And if you sort of disaggregate what we paid for the Lighting business as part of Cooper, it's not an awful lot different than what we sold it for. And now we thought that the business could migrate in certain ways and mailed closer to the broader Electrical franchise and it really has not and that's one of the reason we believe it's more appropriate as part of another Lighting enterprise or possibly as a public company, which was our original game plan but we would argue that we haven't dramatically impacted value in the case of Lighting. If it happen sometimes businesses don't end up developing in a way that you expect.

Rob McCarthy

Alright. And then in terms of the cash generation of the businesses, I mean, in the context of how you're thinking about your trough and the cash EPS trough, certainly, I think you would highlight rightfully so strong cash conversion overall. Are you still subscribing to the kind of the trough and the way to think about the trough as you articulated earlier in the year and as anything change there with respect to either cash generation in the down cycle or the trough itself, can we rely on that as we kind of anchor to win work particularly as we go into a tougher macro economic environment?

Richard Fearon

If you're talking about by trough, well our cash flow change markedly in a down year, we still believe it's not likely too, right and simply because we liquidate working capital that offsets the profits loss through lower volume. So, even if we had down year at some point in the next couple of years, we don't think you'd see a market change in cash generation and one other point I would like to make about cash flow, I think it's important if you think about our free cash flow in 2019 based on the guidance we've given and that compared to 2018, we're guiding to up 23% and I think that's a pretty notable number. At the end of the day, the real value of most businesses of the cash they generate and we're generating really attractive increases in cash flow in '19 and we would expect continuity and debt cash generation next year. And absolutely cash flow is a very strong. I guess what I was alluding to specifically was the framework I believe Craig laid out for a trough scenario we are still arriving to that.

Craig Arnold

Yes. You are talking about, we have at least flat EPS in a trough year and we continue to believe that is the base case plan. And the only caveat we'd add is that we said post the spin off of our sale of Lighting and post this divestiture of FCD and we would expect to get the FCD transaction done by the end of the year, and lighting some timing in Q1 but post those transactions we absolutely have the plan and fully committed to delivering flat EPS what we call a typical economic recession which we define is two to three quarters of GDP contraction.

Rob McCarthy

Thanks for your time. I appreciate it.

Yan Jin

Good. Our last question comes from Deane Dray with RBC.

Deane Dray

Thank you. Good morning, everyone.

Craig Arnold

Hi, Deane.

Deane Dray

I was hoping to get a spotlight on a specific geography and a vertical, what can you tell us about China, the tone of business, the outlook and then data centers has come up during the call, any specifics there in terms of the outlook? Thanks.

Craig Arnold

I appreciate the question, Deane. I think China, if you think about across the broad swath of businesses that we deal and maybe deal with a positive first I'd say kind of the non-res construction and quite frankly even res construction in China actually continues to perform very well and you see some of this data as well. But that will off starts in Q3, we're actually up 10% and are up 16% year-to-date. Residential starts are up 6% in Q3 and 9% year to date. And so the whole kind of construction market in China is doing well. And quite frankly, even on the Hydraulics side excavator sales continue to grow quite nicely in Q3, up 16% and excavators and up 7% in real world and so that piece of the business in China is actually doing quite well. By contrast, light motor vehicle production is down quite significantly, down 7% in Q3 and 12% year-to-date as well as heavy duty truck production is about flat. And so, it really is a very different story depending upon which end market you referring to. But in the most important part of our company, let's call it, in the Electrical side non-res construction the market is holding up quite well.

Deane Dray

Great.

Craig Arnold

And then typically the data centers, as we mentioned in the opening commentary, in our data center business performed very well in the quarter. We ended up seeing high single-digit growth in data centers and so that market continues to perform very well. And as we've mentioned on other earnings calls that the hyperscale stuff does tend to be lumpy, and we continue to see that lumpiness, but by and large, we continue to see very good growth in data centers.

Deane Dray

Craig, just last one for me, the lowering of the CapEx by $50 million. Is there any story behind that?

Craig Arnold

No, I'd say that's just really fine-tuning the outlook for the year. Our businesses tend to be low optimistic. The only course of the planning process around what they can get done, that's really just largely a true up. We've not done anything to put any clamps on our capex spending. We're still spending on every program that we can get done.

Deane Dray

Great, thanks for the color.

Yan Jin

Great. Thank you all. We have reached to the end of our call. And we do appreciate everybody's question. As always Craig and I will be available to address any follow-up questions. Thank you all. Have a good day.

Craig Arnold

Thank you.

Operator

Ladies and gentlemen that does conclude your conference for today. Thank you for your participation. You may now disconnect.