KION GROUP AG

Investor & Analyst Call

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Speakers: Rob Smith (CEO and CFO Ad Interim)

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Sebastian Ubert	Yes, thank you, Stewart. Good afternoon and good morning, and thank you, everyone, for joining this call. We would like to use this as an opportunity to explain in a little bit more detail about the news which we published yesterday late and to answer your questions. So without further ado, I will hand over to Rob Smith, CEO and Interim CFO of KION Group. Rob, the floor is yours.
Rob Smith	Thank you, Sebastian, and good afternoon and good morning to all. We will, for the first time since KION went public in 2013, post an adjusted EBIT loss between minus €100 million and minus €140 million in the third quarter 2022 on the KION Group level. Our current Q3 expectations for our Industrial Trucks & Services segment should not be any surprise to you. Sales and adjusted EBIT should be close to the levels seen in the second quarter this year, and order intake should start to normalize following strong growth in previous quarters, as we set out in our Q2 call. Shortages of parts and components are expected to continue. During the third quarter, a critical supplier of electronics had to temporarily suspend production due to a cyberattack. We're working very closely with our supplier to mitigate the consequences and currently expect them to have a limited impact on adjusted EBIT in the remainder of this year. We do expect a temporary adverse effect on our net working capital, however. This is a very typical example how our business can be suddenly affected by disruptions in the supply chain, over which we have limited control.

Measures initiated in ITS, like agile pricing, strengthening our supplier network, and establishing alternative supply channels, have already started to show effect. The business has been successful in reducing the number of at-risk suppliers as well as reducing the inventory in semifinished trucks from 12,200 semifinished trucks at the end of the second quarter to below 8,500 at the end of August.

We obviously don't have the numbers for September yet, and they may be adversely impacted by the cyberattack at one of our suppliers even though we're not seeing that impact yet.

The situation in our Supply Chain Solutions segment looks very different. Order intake in the third quarter will be affected by reduced demand from e-commerce customers, by project postponements, and very selective order cancellations.

On the adjusted EBIT level, SCS is anticipated to show a loss between minus €160 million and minus €190 million in the third quarter this year.

How did it come to this development? We, like you, have seen, the adjusted EBIT margin of SCS decline sequentially since the fourth quarter of 2021. In fact, you will recall that we highlighted this in our second quarter earnings call in July. The published margin of 7% had benefited from positive one-time effects in the low- to mid-double-digit millions amount. This meant that the underlying adjusted EBIT margin had dropped from 7% in the first quarter to 4% in the second quarter of 2022.

In August, higher costs on a number of projects led us to initiate a further in-depth assessment on the project portfolio, and our

team has been working relentlessly to understand the eroding margins in this business.

The analysis identified the following root causes for the negative profitability development. The costs of materials, labor, and logistics have been increasing, in some cases dramatically and very rapidly. Given the nature of the SCS business, which includes projects that have been calculated and priced and were sold as far back as 6 to 24 months ago -- and those projects are being executed now -- we’ve had to recognize that there are significant gaps between the costs in the project calculations and today’s reality.

So far, SCS has only been able to pass a minor portion of the cost increases on to our customers, as we did not have contractual cost escalation protection in place.

Also, supply chain disruptions continue to impact existing projects, leading to labor inefficiencies and delaying their completion. This means we have a lot of engineering and implementation teams deployed on sites but unable to finish the work because of delayed parts and components, leading to significantly higher total project costs.

At the same time, new projects have started, but with engineering teams and implementation teams still finishing previous projects, they’ve not been available for all the new ones. In addition, we’re experiencing labor shortages, particularly in North America, which makes hiring additional employees on short notice a challenge.

In a nutshell, we were confronted with a volatile and inflationary supply chain environment in a period of very strong growth, and this has revealed substantial challenges within our internal processes.

So now we take action. Let me explain how we're intensifying our initiatives and adding further substantial steps. In the second quarter of this year, we introduced price adjustment clauses in our project contracts, allowing us to more effectively pass through cost increases to our customers. We're also working with our suppliers to lock in costs early in the project lifecycle. These measures will allow us to respond flexibly to procurement cost increases during the usual 6- to 24-month project timelines.

Additionally, we're updating our existing project management processes to better plan and implement our projects to make those processes more agile and more robust in a volatile macroeconomic environment.

We continue to build on the great innovation power of SCS and its state-of-the art supply chain solutions and technologies to benefit our diverse customer base.

The long-term nature of the project business implies, however, that it will take time for the measures to take full effect.

We've also published a new guidance for the full year 2022 yesterday. I'll take you through it, and this is all on the KION Group level.

Our order intake we expect to come in between €11.6 billion and €12.5 billion. We expect to finish this year between €10.45 billion

and €11.25 billion of revenue. For adjusted EBIT level, we expect to come in between €200 million and €310 million.

The free cashflow we anticipate coming in between minus €950 million and minus €700 million. And finally, for the return on capital employed, we expect to finish between 2.5% and 3.3%.

Our guidance continues to be subject to considerable uncertainty, given the ongoing deterioration in the macroeconomic environment, the escalating energy crisis, as well as persistent supply chain shortages and the risk of further rising procurement costs.

Regarding the medium term, we are confident to return to a profitable growth path. We operate in attractive market segments where we benefit from a number of megatrends, including automation, urbanization, sustainability, and e-commerce. Our business model is intact.

And this is why we confirm that a double-digit adjusted EBIT margin of 10% to 12% is the best reflection of the potential of the KION Group, derived from ITS adjusted EBIT margins of more than 10% and SCS adjusted EBIT margins of 12% to 14%.

With the business performance in 2022, we've moved further away from achieving our former midterm targets, and the macroeconomic environment is expected to remain quite volatile for the time being. Therefore, the timeframe for achieving these targets remains under review.

Sebastian, let's open the line and take some Q&A, please.

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Sebastian Ubert	Yes, thank you, Rob. But before I hand over to the operator for the Q&A session, I would like to ask for your understanding that we will answer your questions to the best of our current knowledge, but also please note that we are still in the middle of September. So, we don't have full visibility on the full third quarter yet beyond the indication that we have sent to you last night and Rob has just explained.
	Also, regarding further details on the development at SCS in the third quarter and the measures that we are taking, please remember that, according to German ad hoc publicity laws, we have to publish share-price-sensitive information immediately, which means that our ability to shed more light at this time is limited.
	We will continue our analysis of the root causes as well as the development and the implementation of changes and measures over the next weeks and months and will provide regular updates to you via our quarterly reporting.
	Finally, in the interest of time and allowing us to answer as many callers and questions as possible, please limit yourself to two questions per caller. If there is time left over after the first round, we will poll for additional questions. Thank you in advance for your cooperation.
	And with that, Stewart, please start the Q&A session.
Operator	Thank you, Sebastian. Ladies and gentlemen, at this time, we will begin the question-and-answer session.

Akash Gupta

Yes, hi, good afternoon, everybody. My first question is on the balance sheet that, if I do my calculation based on your free cash flow guidance and new EBIT margin, it looks like the leverage is going to be very high, something you did have since 2016, when you closed Dematic acquisition.

Can you talk about need for capital increase to protect credit rating? And are you also considering delaying some of the capex and suspending dividend next year? That's question number one.

Rob Smith

Sure, Akash. I appreciate you bringing that question up right at the very beginning. We are very comfortable with our capital position, and we don't see a need for a capital raise.

First of all, we've got access to multiple debt capital sources and have significant underdrawn facilities. Couple examples, we recently enlarged our commercial paper program up to €750 million. We also in the second quarter added three bilateral loans, each of €100 million and maturing between '23 and '26.

I think the most important thing to understand is that our business model is very intact, and we're generating a positive EBIT on an underlying basis, and that's a tailwind for the cash position.

The primary reason for our negative cash flow development is increase in working capital. And that's attributed on the ITS business to the unfinished trucks and the semifinished conditions we've been describing. And we have deliberately chosen to build up our inventory on steel components and electronic components, which are very difficult to get, in order to give us a good resilience.

And on the Supply Chain Solutions side, we're not able to reach project milestones as planned based on material deliveries coming, and that affects our ability to invoice customers. Being able to work through these over time gives us a working capital expectation that remains higher than in previous levels, but we are comfortable that we can reduce that over time as we drive down the work in progress and we invoice the milestones.

You ask about -- so we do not see a need for a capital increase, and we're not in a position to be concerned about breaching covenants. We've got two investment grade ratings, and we're in a good way on that.

You ask about capex. The capex is something that we are not changing our strategic capital plan. We will continue to drive our strategy as we have it. The timing of some capex, of course, will be demand and capacity related.

We have a dividend policy in place, and we expect to stick with our dividend policy and come in within the range that we have on our dividend policy.

Akash Gupta

Thank you. And my follow-up question is on your cost base. If you look at the orders in the second half as implied by the midpoint of guidance, you are indicating high teens order decline in the second half.

And on this weak demand backdrop, when you look at your cost base, and I see wages last year were roughly 25% to 30% of your cost base, and given the inflation environment, it will go next year, can you talk about cost-saving plans that you think might be

needed to restore profitability, or can you sail the storm without any big cost-cutting plan? Thank you.

Rob Smith

Akash, we are always conscious of our costs. I think you're talking about sailing the storm, and let's talk about the tailwind we've got. Both of our businesses have a very significant order book at this point in time. And our SCS business has a good pipeline going forward.

There may be some timing issues on customers making choices on when they start, and we know that our project portfolio has large projects in it, and it's lumpy, so the timing of those starting and stopping. But we've had below €1 billion and above €1 billion over periods of time. We've got a good order pipeline, and we've got a good order backlog. And that will give us some good tailwind going into times of perhaps reduced demand in the market.

We have an ability to flex our costs as well should we need to. We're very cost conscious, and the opportunity to flex our labor with short-time working, for example, or, in our SCS business, we have contracted labor. So, we can flex our abilities.

This is a self-help opportunity, Akash. We can drive our profitability and drive our business performance, and it's about improving the process or improving the execution and the profitability on our project execution, and we're in the process of doing that. So, we can adjust our costs as necessary, and we have a good backlog going into the next quarters.

Akash Gupta

Thank you.

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Sven Weier

Yes, thank you. And good afternoon, Rob and Sebastian. I hope you're both well. The first question is on the backlog of legacy projects. And I was wondering, so those with the cost issues, what percentage of those orders are still going to be shipped during the remainder of the year, and how much does actually spill over into next year and '24?

And the basic question also, do you feel this is now ring fenced? Do you think that you have all the costs visible and locked in, or could we see further additional charges? That's the first one.

Rob Smith

Sure, Sven. Thank you for that question as well. In August, we saw higher costs on a number of projects, and that led us to initiate this further in-depth assessment on our project portfolio. And as I explained, we saw significant cost increases on the material, labor, and logistics side and did not have contractual protection in place there. And the supply chain disruptions were driving material not being available and having in total significantly higher project costs.

As you know, in our project business, we use project accounting, and that's a percentage of completion basis. And this quarter, the assessment of those existing projects identified higher costs from those disrupted supply chains, material costs and labor scarcity. And we see that intensifying. And we see it remaining longer than previously anticipated.

Therefore, in the third quarter, we booked a cost catchup in the current quarter based on the proportion of completion of these projects. And given that a large amount of the projects had a high percentage of completion, that's the majority of the effect.

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It's important to understand that that increased project cost reduced the margin of those projects. And to the extent that those projects aren't yet completed, they will go into the further quarters and continue to depress margins on those projects until they get completed.

As those new projects -- or as the old new projects get replaced by new projects, however, and the new projects are protected by price escalation and cost escalation clauses in the contracts and benefit from the improved project management processes, our profitability -- we will drive that profitability increase over time.

You understand, please, that our projects operate on 6 to 24, sometimes even 36 months. The projects we evaluated at high percentage of completion have been in our -- we sold them, and we've been working on them for the last 6 to 24 months, and there's a large amount we're at high percentage of completion. That's the significance of the third quarter reduction, the catchup. Going forward, we expect to operate at those lower margins until they're finished.

Sven Weier

Okay. I understood, but is it still a lot that is to be completed then next year, and it's going to have a meaningful impact on next year's margins as a whole? Because on the one hand, you say these projects are close to completion, and that's why there was such a big amount. On the other hand, you have long lead times. So I just wonder how meaningful this could still be as an impact on the P&L in 2023.

Rob Smith

Sven, I do expect that these projects will roll over into next year. And the impact of those will roll over into next year.

Sven Weier

Good. Thanks for that. And second question is just, when we think about underlying demand, right, you made a few comments in the press release. I think a lot of that relates to high comps, right, in SCS. You had super high comps in Q3 last year, which was always an ungrateful comp to compare with. In trucks, you have a super high comp in Q2. So we would have expected a normalization against that anyhow without a step change in what's going on underneath in terms of real client demand.

But have you also observed now in the last 2 months a critical change in the underlying demand? You sounded like the pipeline in SCS was still sound, but have you observed any of that?

Rob Smith

Well, you're very right to be pointing out the high comps. Our third quarter SCS orders last year at €1.4 billion was an all-time high. And €830 million, as we're projecting this quarter, we think could be -- it's above €1 billion. It's below €1 billion over time. We still think that's still in a normal way.

The pipeline as I continue to see it remains good. The timing of customers starting those projects could be pushing out. I think that there's a normalization on the ITS side and no critical changes there. And as you know, a lot of our revenue in ITS, over half of it, is service revenue. And in the new truck business, a lot of those are on lease, and they roll over.

And so, we see a normalization from -- on the truck side, a very, very strong first half. And we see on the third quarter the tough comparison. The overall market we see as not a significant reduction in the overall market. Could be timing on some of the large projects, and that could be at this quarter, next quarter. It

depends. Those are lumpy, and they're getting bigger. But in general, we see a good pipeline.

Sven Weier — And so the cancellations were also kind of an exception in SCS. It's not a kind of a new normal that we should see more of these.

Rob Smith — No, that's a very good point. It is quite unnormal to have a cancellation on the SCS business. These customers are tying those decisions to their long-term capital plans and their long-term strategies. These were two very specific cases. It's not a normal, and we don't expect a lot of that. Thank you.

Sven Weier — Thanks, Rob.

Will Turner — Hi, good afternoon, Rob and everyone else. I have a couple of questions. The first one is on the earnings and the free cash flow guidance for beyond 3Q. So obviously, if we take that, the midpoint of your new full-year guidance, you're assuming that earnings are going to -- or margins are going to improve for both ITS and Supply Chain Solutions in the fourth quarter. Could you just walk us through a little bit about your assumptions there on why that would happen and then also how you're expecting the working capital to move in the fourth quarter as well?

Rob Smith — Sure. Let's pick that up one at a time. The timing and the adjustment in the third quarter is a percentage of completion effect, significant in the Supply Chain Solutions business, and we've gone through that.

The expectation on the ITS business is a function of having put the price increases that we've talked about in previous quarterly calls in place sequentially and increasingly over the course of this

year, and those will be flowing through our P&L in the quarter to come or in the quarters to come.

You asked about net working capital. Obviously, it is at a high, and we're working on driving that and managing that very closely. We have expectations in each of our businesses to manage that down over time. I think that it's an overall -- as we get into a new normal, the new normal net working capital will be higher than the previous normal net working capital. But as I say, the interim period of driving through and driving down our work in process and getting our milestones completed on the project side will improve the net working capital as well.

Will Turner

Okay. Sure. That makes sense. On the Industrial Trucks business, but will you not still be delivering in the fourth quarter trucks that you booked from before your price increases clause that you introduced in the second quarter, so ones from maybe 4Q '21 and the first quarter?

Rob Smith

Yes, Will. We have explained that we made an adjustment at the beginning of this year. We made an adjustment in April. We made adjustment again in July. We've been doing that on a quarterly basis. And so over time, the trucks from -- sold last year that were not benefiting from those price increases will diminish. And the trucks that were sold after those price increases will increase in the proportion of the trucks being sold.

In addition, we've talked about that as well. We talked in the second quarter of the order book was not taboo. And our team has been working very carefully and closely with long-term valued customers to make adjustments in the existing order book. And

that will make some benefit in the rest of this year because of successes in those discussions with good close customers.

Will Turner

Great. Thanks. And then a final question from me, going back to what Akash was mentioning at the beginning, when you do use your new guidance and you look at the leverage, you are on the net operating industrial debt to the industrial EBITDA, which I believe is what you measure your covenants against, it is the highest it has been since 2016. And there was a number of equity raises that came after that.

Could you please let us know what your covenants are? I believe you've got some for both an RCF and the bonds. And if you were to breach one of them, what would be kind of the implications?

Rob Smith

Sure. Look, our current financing does not depend on the covenants. The RCF functions as a backup line only. And we have investment grade covenants. And because of the investment grades, our covenants are not being tested.

Our current instruments, we've got promissory notes. We've got commercial paper. We've got bilateral bank loans. We've got a bond and very significant amounts of undrawn facilities against those multiple debt capital sources. So we're good on that, and we don't discuss the specifics of our covenants.

Will Turner

Okay. Great. Thanks.

Sebastian Growe

Yes, good afternoon. Thanks for taking my questions. And sorry for any background noise. I'm traveling. The first one is around the group margin targets in the midterm. I was just really struggling with, how can you be confident at all, quite frankly, with

those very midterm margin targets after what has happened today and particular at Supply Chain Solutions?

And should we rather consider these targets as a peak level instead of a through-the-cycle ambition? And the background of that very question is that both segments have probably lived in the best of all worlds from I think a growth and also a pricing and thus margin perspective for quite a long time. So, we've also heard Daifuku, I think, taking a more cautious tone on the US market. So yes, your thoughts around that would be very much appreciated, and then I have one more, obviously.

Rob Smith

Thanks, Sebastian. Yes, look, Sebastian, our business model is very much intact. Our industry benefits from very strong megatrends. We've talked about those. And we've got very good innovation power and very good state-of-the-art offerings.

We have confidence in these targets, and we have our confidence in our ability to do that. And our expectation of getting to 10% to 12% on an overall basis with more than 10% in ITS and 12% to 14% in SCS, we confirm we're working on the timing of those, given the uncertainty right now.

Sebastian Growe

But you would agree with eventually the observation that pricing has probably gone extremely well in the past, I think. That was eventually simply not that much of a discussion. But still, I think the market was really on fire. So, everybody was just keen on securing those very projects. So, it was simply a sellers' market, quite frankly. So, things have changed. The market is, I think, more consolidating, etc. You think that has no impact really on the business and how one should think about future margin?

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Rob Smith

No, I don't share the view that pricing has been a big deal in the past. Pricing was very, very moderate in the past, in my observation was too moderate in the past. And we have put up pricing. And we've done that consistently. And I was watching very closely to see if the up market continued to take demand after we put up the pricing, and it still does. And we've got a good order book on that. So, my expectation is that we are able to drive and achieve these midterm targets. The timing of that we'll be coming back to as we have better clarity with less economic uncertainty.

Sebastian Growe

All right. And we see all this playing out. And the other question I had is more personnel related and the succession obviously of the CFO. It's now about 7 months since the announcement that Anke was leaving the company. And I think the current situation probably signals an ever-greater need here. So, can you comment on where you stand today and by when we might expect an announcement? And equally important for me, has a profile of the ideal candidate eventually changed after what has happened?

Rob Smith

Sven, we've got a search ongoing. It continues to be in progress. And we'll be coming back when we have news on the CFO search. We don't have anything to report at this point in time.

Sebastian Growe

There's no due date, so to speak, until when you will have that cleared, say, by end of the year. So, it's really entirely up in the air. Is that the way to look at it?

Rob Smith

Sebastian, the search is underway. And when we have news, we'll be bringing that news.

Sebastian Growe — All right. I'll go back into the queue.

Nicholas Green — Hello there. Thank you for taking my questions, Rob. So, I'd like to understand whether the €3.8 billion SCS order book, is it facing specific problem projects, or whether there is a wider-spread commercial issue?

So, I've got a series of questions to try and help dimension that problem. Any color you can give will be helpful, please. So firstly, approximately how many large contracts are sitting in that order book? How many over €100 million? What percentage of the total would the top 10 comprise?

Secondly, did yesterday's write-down put certain of these contracts to zero margin? You said you reduced the margin, but can you confirm, are they now at zero margin? How many projects there are we talking about? And specifically, you mentioned they are quite far advanced. Are you able to shed light on their percentage of completion? It does matter quite a bit whether that's 50%, 75%, or 90%.

Thirdly, can you share with us what share of the order book is likely to be less than 30% complete but which was also won prior to the improvements in your contractual terms in Q2 this year?

And then finally, which is what they all amount to is, how should we think about the level of the embedded margin sitting in this quite large SCS order book? Thank you.

Rob Smith — That's -- you got in a lot of questions there, Nicholas. And I'm going to ask you to take some of those offline with our IR Department and do that bilaterally. But we've got a -- the order

book that we've been describing is an order book that we built over time. We have 6- to 12- to 24- to 36-month projects in there. And we put in place cost escalation, price escalation clauses during the second quarter going forward.

So, you're asking about the mix in there, and you're asking about the profitability. In times of less uncertainty, not an issue. In times of uncertainty, and that's what we are in now, and we adjust -- we assessed that carefully in August, and we adjusted the project cost in August. And that was a clear and fair assessment of that. And so, the margin in that order book will improve based on the contractual escalation clauses that we put in place going forward. And as those projects -- old projects run out and new projects run in, that will make a margin -- a positive margin impact.

The biggest impact was in the third quarter on the catchup.

Nicholas Green

I think -- thank you. I think, dimensioning the risk of the order book, it will depend on how big the quantity of work is between the ones you've just written down to a low margin and the new price benefits coming in.

You say you'd won the work over the last -- I think you said earlier in the call 24 months perhaps. Well, if the price contractual improvement only began in Q2 this year, there could be potentially an awful lot of work in there which wasn't that far advanced and therefore maybe didn't suffer much of a margin write-down and therefore be a significant profit risk over the next 12 to 18 months.

So, I know you can't answer that directly, but can you at least tell us basic ideas of how many contracts are in this order book?

	Could you tell us the top 10 total percent -- rough percentage of the total order book, just to help dimension the risk that we're seeing here?
Rob Smith	No, Nicolas, we don't dimension that in that kind of granularity, and we haven't done that, and I'm not going to do that today either. Some of those projects are over €100 million. Some of those projects are under €100 million. There are big ones in there. There are small ones in there. It's a mix. It's a mix on geography. It's a mix on size. And very excitingly, it's in multiple different customer verticals. So, it's -- there's good diversity in there. The timing and the profile is -- the granularity we don't get into.
Nicholas Green	Okay. Thank you for that. I'll turn it back.
Gael de Bray	Good afternoon. Thanks very much for the time. I apologize in advance to labor the point on the balance sheet, but I'd like to compare today's situation with 2020 if possible. You will likely finish 2022 with a debt pile that will be likely pretty similar to the one you had at this point in the year 2020. And back then, the group raised equity to regain some financial flexibility or to potentially get prepared for acquisitions. So I'd like to understand from a strategic perspective, what's different today? What's different this time that makes you consider you don't need a capital increase? So that's question number one. And maybe associated to this, could you just give us some indication on what you consider is an appropriate or a targeted financial structure for the company?

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And sorry, the second question is about the working capital buildup that -- it would be great if you could give us a sense of how much -- roughly speaking, how much of this year's working capital buildup could possibly reverse out next year.

Rob Smith

So, Gael, let's pick up on some of those, and let's choose not to answer some of those. I think there's a big difference between 2020 and 2022. I think, in 2020, there was very, very significant uncertainty still in the market on the pandemics. And at that time, our ITS order book was not near the levels that it is now, very significant difference in visibility on orders and activity going forward and very significant visibility and perception in the market on the pandemic.

I repeat, we're very comfortable with our capital position, and we do not see a need for a capital raise. We've got multiple debt sources, debt capital sources, and significant undrawn facilities. So, we're comfortable on that. We've got two investment grades, and our covenants are not under pressure here. We've got a good financial situation and plenty of access to financing. So, let's make it clear on those points there.

Gael de Bray

And what's the targeted financial structure over time?

Rob Smith

Yes, Gael, we're comfortable on the current status, and we're going to continue on this level.

Gael de Bray

Okay. Okay. Thanks. I understood -- sorry, and the question on the working capital buildup and how could that could --

Rob Smith

Yes, let's talk about that one. We built up the working capital in 2022, and we expect that part of that will remain for some quarters because times of just-in-time supply chain deliveries are times when we all look back at and we enjoyed very much, but the supply chain interruptions and the supply chain uncertainty is causing people all across the industry to carry more working capital in terms of inventory right now.

We built up specifically steel and electronic components because they're hard to get, and when you can get them, we do get them to secure production. So, I expect that the working capital will remain on a higher level going forward than it did in the past. As we get more material in and are able to finish further trucks, and as I described, we've been able to reduce that 12,200 to less than 8,500 by the end of August. Our team is very focused on that. And as we build through that -- as we draw that inventory down, that will release working capital.

Let's also be clear. If you're still waiting on parts and they're not showing up on job sites, you cannot get to the milestone that releases the cash when you can invoice at that milestone. And there's some frustration on -- or frustrated deliveries that don't allow the milestone completion. As we get those milestones, as we finish those projects, that will reduce the working capital.

Let me remind you. Our Supply Chain Solutions business is in a normal environment, got negative working capital. So, this is an unusual situation, and we're managing through this, and it will over time reduce the working capital needs.

Gael de Bray

Thank you very much.

Daniel Gleim Yes, good afternoon. Thank you very much for taking my questions. Rob, could you scale the cost catchup effect in Q3 in the SCS segment? What was the roughly size? What I'm trying to get here is how the underlying margin in SCS in the third quarter compares to the 4% you previously alluded to.

Rob Smith Daniel, I think that Sebastian said it earlier on. We're not done with the third quarter yet. And so, let's wait until the 27th of October when we come back with our third quarter review, and we'll have that in granular detail as when the quarter's finished.

Daniel Gleim Maybe as a follow up, if I look at your full-year guidance and the rough indication for the third quarter and therefore the -- for the first 9 months, the implied fourth quarter, is the reported number there an underlying number, or do you expect further positive or negative catchup effects in the fourth quarter? Are you done with this exercise, or did you bake into your guidance another catchup exercise in the fourth quarter?

Rob Smith Look, the assessments we made and we make every month are free and clear and fair based on our best understandings and best expectations. So the third quarter adjustment and the fourth quarter going forward are based on our best understandings and our best assessments.

I think, over time, we will see, as we described, the price impacts and the impact of the price increases that we have put in place sequentially in our Industrial Truck and Service business. And we will see over time the impact, the benefit of the price escalation clauses in both of those businesses, including on the contractual or the project contracts in our SCS business as those new

projects come into production over time or go into execution over time.

Daniel Gleim

But could sequential further completion of projects mandate another round of cost catchup effects in theory? Is that possible?

Rob Smith

That's percentage of completion accounting, Daniel. And each assessment, you give it your very best estimate based on all of the understanding and the current prices and your expectations on futures. So, you understand the theory just as well as we do. In theory, yes. In practice, we gave it the very best assessment, given everything we know, and our expectations on the future.

Daniel Gleim

Very clear. Apologies for belaboring the point. My second question is probably more straightforward. Is the order intake guidance for the third quarter and the full year net of the order cancellations, or is this a gross number?

And secondly, what was the magnitude of cancellations in the third quarter?

Rob Smith

As I said, Daniel, there were two projects cancelled in the third quarter. That was a very unusual thing. Of course, we report net order intake, and the two cancellations were netted out of the third -- will be when we finish the third quarter and report it, will be netted out of the third quarter order intake numbers. So clearly, they're net.

Philippe Lorrain

Yes, thanks very much. I would like to bounce back on the last question regarding the order cancellations. So, I understand two projects netted out of the order intake in Q3. So that suggests

	that these were booked first in your intake either in Q1 or Q2. Is that correct?
Rob Smith	Yes, that is correct.
Philippe Lorrain	Okay. And could you tell us roughly the magnitude of these cancellations, just to get a sense of like how much is missing and how big these issues are?
Rob Smith	No, we don't give specific magnitudes on those. But as I say, two very specific events based on circumstances at the customer or customers and understandable and quite unusual and not practice. As I say, these are connected to long-term capital plans and the strategies of our customers. And the benefits that our Supply Chain Solutions installations and solutions put in place for our customers is strategic for them and gives them competitive advantages. So that's why they're making those investments.
Philippe Lorrain	Yes, I'm understanding from your -- the way you answered my question that it's probably only one customer behind these two orders. Is that correct?
Rob Smith	I said customers, and that means more than one.
Philippe Lorrain	Okay. And also, I've got a question regarding your contract structure. So, do I understand correctly that all the contracts you had in the past, so before Q2, were under fixed price agreements? Are just all new contracts now featuring the price escalation clauses, or are you also revising existing contracts to feature price escalation agreements when they were not featuring these previously?

Rob Smith

No, contracts when we sign the contracts are the contracts that we go, then put in place and execute. And so, there's very, very little revisions on those. On an ongoing basis during projects, there are change orders based on changes in scope. And clearly, there are discussions about changes in costs. And those are dealt with on a change order base, but the contractual conditions don't change.

That's why it was so important in the second quarter to introduce the price escalation clauses and give us that kind of protection because, if 24 months there's no change in the inflation and no volatility, it's a different story than 24 months into a project with the current volatility and inflation situation. That's why we did that.

And almost all the contracts we've been able to -- we have closed since putting those in place include these clauses. That's part of our governance.

Philippe Lorrain

Okay. And before that, none of the contracts has these price escalation clauses, or some of them had already?

Rob Smith

Very few. The practice in the industry was that those were not a part of contracts in previous times.

Philippe Lorrain

Okay. Perfect. And I've got like one more topic regarding free cash flow and debt. So, I appreciate you guide for quite a significant cash burn, which is understandable, for the remainder of the year. How should we think about the gradual trajectory in free cash flow beyond the year end? So, do you think, because we are going to see probably a normalization in the net working capital and parts as well, like in the earnings base, we should be already positive beginning of next year, or should we expect the

cash burn to continue probably into next year for 1, 2 quarters before reversing back into positive territory?

Rob Smith

We don't make comments on next year until we start talking about next year, Philippe. But let's talk about the cash because, as I was describing, we have an underlying positive EBIT which gives us a good tailwind on our cash position. And the net working capital, the temporary -- the elements of work in progress that is an unusual amount that we're building down based on component availability, as we get that availability, we'll work that down, and that will free up cash and reduce our net working capital.

And the same story on finishing milestones and therefore being able -- the projects -- I guess you were asking about a contract. The contracts often identify milestones during the course of the project period, over the 24 months, for example. And as those milestones with the specific definition of scope are achieved, then the invoices go. And if that achievement of scope is reliant on parts that are not showing up or are delayed, the milestone gets delayed. So, as we achieve those, we get to make -- we will make those invoicing, and that will improve the cash and reduce the net working capital, too.

And as I described earlier, the net working capital is usually negative in our Supply Chain Solutions business based on down payments and advanced payments.

Philippe Lorrain

Yes, so I guess like really, like for your net working capital right now, it's really more like the project business that impacts the whole visibility that you have because you can say pretty

confidently that the inventory levels in IT&S is going to fall again once the peak is passed.

Rob Smith

Let’s try it again. The missing components that are coming in -- the work in -- the trucks that are almost completed are missing on average 2 or 3 parts. As those parts arrive and we’re able to finish those trucks, we reduce -- it reduces the work in process. It’s all dependent upon receiving parts in order to complete the trucks.

Those parts continue to arrive. We continue to reduce the inventory. There are interruptions in the future that slow that down. That will slow that down. But over time, we do expect that we will get those, and we will be driving that down. And over time, we’re confident in finishing the project milestones, getting the material onsite, being able to complete the work, being able to get to complete the milestone, and therefore generating the invoice and reducing the -- increasing the cash and reducing the working capital.

So over time, these will work -- we will work through these. I said one more time -- earlier, I was explaining that I think, in total, in the future, net working capital will be at a higher level than the average in the past because of an expectation of continued volatility and people keeping a certain amount of stock to keep their productions working well or in some cases securing material earlier in projects. So, I think the working capital will be higher going forward, but it’ll certainly be down from the high levels it is now.

Denise Molina

Thanks for taking my question. Hey, Rob. I’m not going to ask you anything specific on this particular quarter. So that’s a relief.

	But really just want to ask you about sort of the nature of the contracts for the SCS and the timing of the cash. So, first question is whether or not you get cash up front and if there's some cash then on the balance sheet that's sort of ring fenced for these projects when they're first taken on by you.
	And then the second question is, is there at any point in the contract when it can't be canceled? And when is that, if you could maybe just talk about that? Thanks.
Rob Smith	So, Denise, the way those projects and those contracts are usually set up is there are indeed in most cases down payments, working on the engineering hours and things like that. So usually, there are down payments, and then as you achieve a milestone, there's another payment associated with that milestone, and then there's final payments -- with each milestone, there are payments associated. And as there is upfront payment, that's why it's usually cash -- or net working capital negative. Are they ring fenced? No, they're not ring fenced.
Denise Molina	And the cancellation, is there any point where they can't cancel or scope down the projects?
Rob Smith	Well, usually, those projects are quite well defined upfront, and it's a significant installation, and it all works in concert when you put the whole thing together. And so first of all, very few cancellations, as I described. They're quite unusual to get one because they're part of the customer strategy. And second of all, changes in scope are not frequent either. That would be an exception as well.
Operator	Denise, are you finished with your question?

Denise Molina | Actually, could I just ask then, is there any cash on the balance sheet related to the projects that are already in play that maybe you can't really use to finance the underlying cash flow negative situation?

Rob Smith | I get your question. No, there's not anything ring fenced that we don't have access to.

Denise Molina | Thank you.

Alex Virgo | Thanks very much, Rob, Sebastian. Thanks for squeezing me in. I just wanted to understand a little bit more around your comments with respect to the slowdown in demand or reduced demand from e-commerce customers and the reasons for the cancellations of customers that you called out there, the two projects you called out.

Trying to understand, I suppose, really, how much of a broader implication that is, why you're seeing that reduced demand, and what is it that you see in terms of conversations with those customers that gives you confidence that it's a temporary thing?

And I guess that's where I'm coming from because an awful lot of what we talked about so far today is sort of quite specific to your execution and lack of protection on the project side. But I'm more curious about your comments on the broader market demand.

Rob Smith | Yes, let's address that several different ways, Alex. The first one is the third quarter comp is going to be tough because last year's third quarter was an all-time high at €1.4 billion. Let's also

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recognize e-commerce is not just a vertical all by itself. It's a very important vertical, but e-commerce plays a role in each of the verticals out there now. And that's been an exciting trend over time and therefore an exciting element of our Supply Chain Solutions business.

This perceived slowdown of e-commerce is a perception -- we need to recall that it skyrocketed during COVID. And there was a very, very strong amount of e-commerce growth in COVID, and there may -- there's a bit of an adjustment now. But the expectation on go-forward e-commerce is very good, and our pipeline, we've got a good portfolio pipeline.

So, our expectations is this is a period of time where maybe a regrouping on the e-commerce as opposed to any long-term trend.

Alex Virgo — Okay. So, this isn't a customer response to any pricing or action on your part and a shift in competitive dynamics. This is simply a pause for breath in an underlying trend. That's your read.

Rob Smith — Yes, that's exactly the correct understanding. Very -- that's exactly the correct understanding. And as I say, the situation was very specific on the two cancellations and quite unusual, so nothing about a trend.

Alex Virgo — Thank you very much.

Operator — In the interest of time, we have to stop the Q&A session. I would like to hand back to Rob Smith for any closing comments. Please go ahead.

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Rob Smith

Thank you, Stewart. Thank you very much. Thank you, each and all, for your time and your interest in KION Group. We appreciate very much your investment in us. We appreciate the opportunity to have these kind of discussions. I will be back to be talking about this at our third quarter earnings call on the 27th of October. Our IR team is available to you all the time to have further bilateral conversations. And I expect that many of us will be seeing each other in the days and weeks to come at the different conferences. So, thank you for your attention and your time today, and look forward to speaking again soon. Goodbye.