ALFA LAVAL AB

Moderator: Tom Erixon
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OPERATOR: This is Conference #: 2183237.

Operator: Ladies and gentlemen, thank you for standing by, and welcome to the Alfa Laval Q3 Earnings Call.

(Operator Instructions)

I must advise you the conference is being recorded today on Thursday, the 22nd of October 2020.

I will now hand the conference over to your speaker today, Tom Erixon. Please, go ahead.

Tom Erixon: Good morning. Welcome to our third quarter earnings call. Let me start as always, with a couple of overall comments to the report, and then we'll go through the presentation.

First, regarding demand in Q3, it remained sequentially stable and on a somewhat of a slow level compared to last year. The parts of the oil and gas market and parts of the Marine markets were specifically weak, whereas the transition to a more carbon-free economy at large is driving increased demand in other parts of the portfolio, especially related to energy efficiency solutions.

The margin was unchanged compared to a strong third quarter last year at above 17 percent. And although we did have a volume decline in sales, it was

compensated by cost reductions and productivity improvements across the value chain in the company.

The forward-looking statement, we will come back to later. But in general, we expect somewhat of a slow global recovery from the current level. And we expect that, this will continue into the next year. And as a consequence, we will see a relative slow demand in parts of our portfolio also going forward.

In that context, after 6 months of short-term flexible cost savings that we implemented starting Q2 with good effects in Q2 and Q3, with the ambition to keep our sales teams and R&D teams together we will gradually now return into somewhat of a more normal operational mode moving into 2021. And instead of the flexible cost reduction programs, we will, in Q4, go through with the restructuring program in order to adjust some of the portfolio imbalances we have as a result of specific declines in part of our portfolio. We will come back with the details on that program latest in connection with the Q4 report.

With that, let me go to key figures. In fixed currency, order intake declined with 9 percent, in line with our guidance compared to Q3 last year. The year-to-date numbers are reasonably stable, given the global turbulence since February, with around 5 percent decline in order intake in sales, respectively and a flat margin, as I said, after a relatively strong 2019. All in all, for the first 9 months, perhaps a little bit better than what we had reason to believe when the pandemic started back in late first quarter.

Let me go to the divisional reviews. And this time, start with the Food & Water Division. We are pleased that the Food & Water Division can shine in this quarter with a strong margin development. Normally, as you know, from you and in our Q&A session, Food & Water Division is not getting a lot of attention. I think it deserves it at this point in time. As expected, the order intake and market situation for the division has been stable in the quarter. And in fact, we have an organic growth, currency adjusted of about positive 2 percent compared to last year.

This is despite the fact that we do have longer lead time for large projects across our company, but also including the Food & Water Division, where decisions on large CapEx projects are taking a longer time to materialize also in this division. I would say at this point that we have a good momentum in the division. We have, as you know, for a number of years, worked with our manufacturing footprint, we have worked with the improvement of our product portfolio, and we have worked with specializing in product oriented, a very competent sales organization globally at this point in time.

And for the Food & Water, built on strong channel partnerships across the geographies. So I think there is a little bit of a reflection of progress in the numbers that you see in the Food & Water. As a result of all of that, the margin improvement was considerable compared to normal levels. We have, when we started a few years ago, been at below 15 percent corporate target at the time. And since then, we've seen a clear trend line to above 15 percent.

With that said, the 19 percent in the quarter was perhaps a little bit exceptional. It was a quarter when everything went right. We were low in cost. We were low in quality costs again, and we had a little bit of one-off tailwinds in the quarter. So while we do appreciate the significant improvement in the quarter, it may overstate the underlying profitability somewhat compared to a normalized level in the division.

With that, let me go to the Energy Division. Overall, we had a weak demand situation. Large projects also in the Energy Division being slower when it comes to decision-making and the upstream oil and gas market remains slow, including impact on our Service business in the quarter due to idling units and idling assets in the area. All in all, it led to a 12 percent organic decline year-on-year.

Still, the demand related to the ongoing energy transition continues to grow, and we see every quarter how we gradually change the mix from fossil-driven business to renewable and energy efficiency like applications. We have for years invested to be a technology provider, enabling the ongoing change in the global energy market, and we are starting to see good results from that.

I'd like to add at this point that Alfa Laval decided to sign on to the carbon-neutral 2030 agenda some time ago in this year. And fundamentally, we are trying to address our own carbon footprint given that we are, in terms of our product solution, certainly addressing the ones of our customers.

The resulting mix changes in the Energy Division from fossil to renewables is supporting the positive margin development that you see in the quarter. Margin compared to last year despite significant volume declines are up almost 1 percent.

Let's go to the Marine Division from here. Demand remained weak in certain areas due to low contracting and a slow retrofit and Service business impacted by the pandemic conditions. Both margins and market shares were stable in the third quarter in most product areas compared to last year. However, the lower margin came mainly as a mix effect in our environmental product portfolio and, to a degree, from lower volumes compared to last year that were not fully compensated for in terms of cost reductions.

We expect that we are somewhere at the bottom of the cycle in the Marine side, expecting a slow recovery from here, supported by important technology trends related to LNG and multifuel and increased carbon awareness among large ship owners.

Let's move on to the Service side. As always, and as you know, in weaker markets, Service has a tendency to grow as a percentage of sales, providing a degree of a natural margin hedge. This is true, as you can see from the numbers, also this time. However, this time, we do see a bit more of a negative volume effects than we see in normal downturns and that is related primarily to difficulty to execute on-site repair and conditioning work.

And in addition to that, we see a little bit more of idling assets during this downturn, certainly in the Marine sector and in oil and gas sector. It is suffice to say that the global cruise fleet is basically completely idle, and that in and of itself, impacts the Marine service business at the moment.

From a 10 percent volume decline, we will expect that the conditions will gradually improve also for Service. And in fact, we did see some signs of improvement already towards the end of Q3. During this period, we have continued to invest in our Service offering.

We have a stronger organization and a better infrastructure than before, and we have made significant improvement in terms of our digital capabilities and see a growing share of service agreement as well. Connectivity as well as remote diagnostic is becoming an important part of our Service offering and it's also visible already now to some degree in our invoicing numbers.

Let me go to the order intake trend. For the group as a whole, Q3 sequentially, as I said, was relatively stable in fixed currency. Generally, large orders across the board have longer lead times. The transactional business is somewhat more stable. Back in February, with all uncertainty, our scenario, A, was a volume decline expectations of around 10 percent to 15 percent in the portfolio. That's in fact where we are.

So we are well prepared, as you can see from the margin and from the fact that our number of FTEs have declined approximately 500 persons since that period of time, we are well prepared to handle this situation. Today, even with the second wave of the pandemic, supply chains continue to work well and the migration from office work to working from home in the digital fashion is well implemented and progressed across the group. Our business cycle scenario from here is that we will see a slow but gradual recovery moving into 2021 and 2022.

Let me then make some regional observations. North America, weak; U.S., week, mainly driven what I commented before on a slightly heavy portfolio in oil and gas and, to a degree, the cruising industry being important as service revenue for the U.S. market. So we see a relatively weak quarter in North America. Eastern Europe is the shining star from a geographical point of view with strong and solid growth across the board, and a very good result from a tough environment also in Eastern Europe.

Asia, and especially China, relatively stable with perhaps the biggest challenges for us is operating a regional structure in Southeast Asia at the moment with the travel restrictions we are facing, but all in all, the situation in Asia has been relatively good. And again, in the quarter, we are above 40 percent of Asia in its share of order intake, again, signaling the importance of the Asian market for our long-term position and growth.

It takes us to our top 10 markets. And I have to say that this quarter is a rather epic quarter for us in terms of geopolitics, if you like. For almost 100 years, the U.S. has been our single biggest market, and we've been substantially present in the U.S. since the late 1800s.

This quarter, finally, China has overtaken U.S. as our single biggest market on a rolling 12-month basis, and I just think it is noteworthy to see the geopolitical change in the landscape happening exactly in this quarter. So we are pleased with the way it's gone in China, and we are pleased with where we are in the U.S. despite the fact that there are some weaknesses currently in the portfolio and the way we're addressing it.

And so with that, I'd like to hand over to Jan for some further financial details on the report.

Jan Allde: Thank you, Tom. And since Tom covered order intake, I will move over to sales. We expected invoicing to be lower than Q3 of last year, but on about the same level as Q2. We realized sales of SEK 9.7 billion in Q3, which is 19 percent lower than last year.

Please note, though, that we had a fairly large negative FX impact on sales in Q3, and excluding this, sales were down 13 percent versus last year and only marginally lower than Q2. With regards to Q4 sales, my outlook is as follows: considering the order backlog versus last year, especially in the Marine Division, I expect invoicing in Q4 2020 to be lower than the same quarter last year, but sequentially higher as Q4 normally is a strong invoicing month.

Then moving over to gross margin. The gross profit margin came in 50 basis points above Q3 of last year. We had a positive capital sales after sales mix in

the quarter. However, due to a large negative product mix in Marine Division, as guided, the total mix impact was negative. Overall quality-related costs were low, and especially in the Food & Water Division, partly offsetting the negative product mix in the Marine Division. The load volume impact was neutral despite lower sales volumes, which means our factories have been quick to adapt their cost structure.

The PPV metals impact was positive, although metal prices have increased in recent months. Finally, we did see a positive FX impact on the gross profit margin in the quarter.

Now over to my outlook for Q4. The starting point is 35.0 gross profit margin reported in Q4 of last year. We expect a positive capital sales service mix in the quarter but also that the negative product mix in Marine will continue into Q4, giving an overall negative mix impact in the quarter.

We expect a neutral load volume impact but a continued positive PPV metals and a positive FX impact versus last year.

And looking at S&A, our development here. So the impact from the cost reduction program continued well into Q3 and came out a bit stronger than we had expected.

In fixed rates, the cost reduction program generated savings of SEK 225 million in Q3, which supported a further reduction of our S&A expenses with a reduction by 13 percent versus last year on a comparable basis. This means the cost reduction program has generated savings of SEK 550 million year-to-date and our S&A expenses are down 10 percent year-to-date on a comparable basis.

Due to the positive development of this program in Q2 and Q3, we have increased our forecasted savings to SEK 650 million to SEK 700 million for the full year 2020 expressed in fixed rates.

As we have stated earlier, this program is temporary in nature, and we now gradually turn into more normal operating mode, which means that the effect of the cost reduction program will gradually decrease in Q4 and into 2021.

Considering this and the soft demand situation in parts of the business, we are now preparing for a targeted restructuring program to be announced latest in connection with the Q4 report.

And as you have seen, the adjusted EBITDA margin came in about the same level as last year despite the lower invoicing volumes, and this is primarily due to the cost reduction program launched in March of this year. The overall quality-related costs, primarily in Food & Water Division, also supported the margins in the quarter.

Now looking at the key figures. As commented earlier, S&A expenses in Q3 were reduced by 13 percent on a comparable basis. Similarly, R&D expenses decreased by 15 percent versus last year, reflecting the reduced activity level in the company during the quarter.

Net other cost and income in Q3 included a loss of SEK 63 million from the sale of a small business in the U.S. Excluding this, net other cost and income was flat versus last year. Financial net, excluding FX impact, was minus SEK 44 million in Q3, in line with last year. The FX gains, losses in Q3 was negative SEK 12 million versus a positive SEK 71 million last year, giving a total finance net of negative SEK 56 million in Q3 versus a positive of SEK 25 million last year.

The tax rate was at 24.9 percent in the quarter, slightly lower than our guidance of 26 percent. EPS was down 28 percent versus last year, mainly due to the lower sales volumes. Please note that during Q3 closing, a classification error has been detected in the income statement for prior quarters this year. Realized and unrealized exchange differences concerning loans that constitute a hedge of net assets in foreign currency are normally booked against other comprehensive income.

The reversal of unrealized exchange losses at December 31, 2019, has in connection with loans maturing during 2020, however, due to a mistake only partially been booked against other comprehensive income. This classification error within the income statement have resulted in a correction of net income and other comprehensive income for Q1 and Q2 2020, but has had no impact

on the reported equity. The impact on earnings per share is a decrease of SEK 0.82 for this first 6 months. And more information on this, you can found in the income statement on Page 18 in the earnings report.

Then we'll go to the cash flow statement. Cash flow from operating activities was SEK 1.2 billion in Q3, on about the same level as last year despite a lower EBITDA level. Working capital increased somewhat in the quarter after a significant reduction in the previous quarter, and working capital reduction continues to be a high focus area for us.

Investing activities included CapEx investment of SEK 377 million in Q3. Financial net paid, excluding FX impact was minus SEK 90 million in Q3 with only a small impact from realized FX gains or losses in the quarter. This means that our total cash flow in Q3 came in at SEK 862 million, on about the same level as last year despite a lower income level.

So due to our strong cash flow generation during the first 9 months of 2020, our net debt position has reduced from SEK 8.2 billion at the end of 2019 to SEK 4.3 billion at the end of September 2020. Excluding the lease liabilities, our net debt position now stands at about SEK 1.9 billion, which equals a net debt-to-EBITDA ratio of 0.22. Hence, we are now operationally moving into a very low gearing of the company in preparation for the outstanding tender offer for Neles.

Then looking at the FX impact, the transaction FX impact on EBITDA in the quarter was a positive SEK 125 million, while the translation impact was negative SEK 115 million, giving a net positive FX impact on EBITDA of SEK 10 million in the quarter. Looking at the projection for full year 2020, we expect a positive transaction impact of about SEK 400 million and a negative translation effect of SEK 225 million. In total, the net positive FX impact of SEK 180 million on EBITDA.

Considering that we have already realized a net FX impact of SEK 160 million year-to-date, it means we expect a fairly small FX impact on EBITDA in Q4 of around SEK 20 million.

Looking at the order backlog. At the end of September, we had a total order backlog of SEK 20.7 billion, which is 8 percent lower than the same time last year and 1 percent lower than at year-end 2019. The book-to-bill ratio was 0.92 in the quarter. Order backlog represents 5.7 months of LTM sales. And for shipment in Q4, the backlog amounts to SEK 7.7 billion, which leads us into then the sales bridge for the full year. So as you've seen, our year-to-date sales number is SEK 30.8 billion, and the backlog for delivery in Q4 is SEK 7.7 billion, leading to a sub total of SEK 38.5 billion.

On top of that, of course, you will need to make your estimate on price and in-for-out and FX impacts. Please note that our estimated FX translation impact on sales for Q4, given the current FX rate is approximately a negative SEK 0.5 billion.

And by that, I hand back to Tom for the outlook statement.

Tom Erixon: So as we indicated to you earlier, our base scenario is that we are around the bottom of the cycle for this time and that we will perhaps start to see a recovery, but somewhat slow. We see a stable demand in many parts of the portfolio, and we will address the areas where we have experienced volumes declined over the last 12 months, specifically in the restructuring program coming in a quarter's time.

The outlook for Q4 is perhaps a little bit more uncertain and difficult than normally for us, both positive and negative, I might add, in terms of predicting the lead time for the large orders in the pipeline. So with that little reservation, we expect to see, overall, a somewhat higher demand in Q4 compared to Q3, specifically, a somewhat higher demand in the Food & Water Division, whereas for the Energy Division and the Marine Division, we expect the market conditions to remain relatively unchanged compared to the Q3.

So with those comments, we open for questions.

Operator: (Operator Instructions)

Your first question comes from the line of Klas Bergelind from Citi.

Klas Bergelind: Yes. Tom and John, it's Klas from Citi. The first question is on services. We know that the comp is start in Marine as we had strong the growth from IMO there last year, and there is a headwind on the cruise side. But sequentially thing seems to be improving. And if we start with Energy, if you look at October in the Energy Division, is Services perhaps flat now or still down?

And also for Marine as well in October, obviously, a tougher comp there. But what kind of volumes do you see here now in the beginning of the quarter?

Tom Erixon: I don't want to move into October already. So let's come back to that in Q4. But we did see in September a somewhat perhaps a better trend on the Service side. If we look at the Service as a whole, it is actually a bit of a scattered picture. If you look at the utilization of our Service center that has been high in the quarter, indicating that customers are sending a fair amount of equipment for refurbishing to our centers as a result of having difficulties receiving personnel on site.

If we look at the spare part sales in the Marine Division year-to-date, as of end September, it's relatively flattish, whereas we see larger declines when it comes to areas of reconditioning and commissioning. And you can say that, that is also, to a degree, impacting the retrofit business, which has similar characteristics in terms of doing planned maintenance work for ship owners. Regardless of the product, the slotting at the repair yards has been difficult giving availability of personnel and service people.

So it is a bit of an uneven picture. But we don't see if there's a structural change to our business. We've seen that it's holding back due idling, due to difficulties, and we expect a gradual recovery on the Service business going forward.

Klas Bergelind: OK. Fair enough. Then my second question is on Neles. And I know this is your firm focus. You've lowered the acceptance level. But in the case the deal sort of falling through and it's not happening, you have a lot of fire power, as Jan said, you are – your later cycle, your earnings will see a drag next year. And I understand that you have a lot of options, I assume, utilizing this strong balance sheet, thinking buyback, other deals. Can I just ask you, Tom, in

terms of – is it other flow assets? Is it in food, sustainable areas? Just so we understand a little bit sort of outside Neles as well, should we not see the deal going through.

Tom Erixon: It is, of course, in terms of deal size, Neles is relatively large. And apart from the good fit and all of that, I don't expect that our deal flow will generate lots of opportunities in that level. However, the deal flow on a small- and medium-sized level is stronger, as I indicated before, than it has been over the last 4 years. I would expect that we have opportunities to close other deals should Neles not come through. And in fact, even if Neles come through, we do have opportunities to address some areas that are a little bit smaller.

When it comes to the industrial flow side, I have to say that as long as the Neles situation is in play, we will coordinate our flow investment with Neles. So I would say at the moment, when it comes to industrial flow, our firm focus is how we can build that business synergetic together with the Neles business portfolio, and not go our own way on it. And so we will hold back on those situations until we clarify the future ownership situation with Neles.

Klas Bergelind: My very final one is on Energy and the mix, and it used to be upstream in fossil that had the highest margin. Now we see this shift to more green sales, and that is also positive for mix, which is really interesting. You're commenting that HVAC and that the business was supported by the green energy transition. Tom, if you look from a sustainability point of view, and you look at total Alfa Laval and in this transition, could you describe this a little bit more how we can go from fossil being a relatively big part of your group still more towards sort of green energy?

Tom Erixon: Yes. It's a big question. I think partly, we'll return to that a little bit at the Capital Markets Day in a month. But it's a very relevant question and observation. And I think to a degree that there is – the situation today, as you can see from the mix change and my comments on the margin improvement in energy that when the oil and gas is going down as a percentage of the whole, our margin is going up.

And so the conclusion is relatively clear that average margin in our oil and gas business are below average of the Energy Division. We see a better profitability, a better competitive situation when it comes to our product offering and the better growth long term, structurally, in the energy transition area compared to the historical oil and gas.

I think it's going too far to say that what we see right now in oil and gas is energy transition only. I mean there is a cyclical short-term effect in the oil and gas market. And the oil and gas, as such, in terms of CapEx cycle will, to a degree, come back in the years to come, I believe.

But it doesn't change our long-term forecast that over a 10-year period, we need to migrate our portfolio much stronger in the renewable and energy efficiency areas. And those investments have been done and will be made in the years to come. And I think it's going to give us a more resilient and a better margin portfolio than we historically had in the energy side.

Operator: Your next question comes from the line of Mattias Holmberg of DNB.

Mattias Holmberg: Could you elaborate a bit on the comment that you make in the report that you say that the expected recovery in ship contracting is now expected to be delayed. So what could the timeline be? And what is the reason for this?

Tom Erixon: It is – I mean we sort of indirectly referred to the Clarkson forecast, which revised down a bit, the ship contracting for 2021, 2022. And given that we are so low in contracting in 2020 in general, we still see a recovery and expect a recovery in 2021, but still to a relatively modest level and very gradual.

I'd like to highlight that, of course, we look very closely at what we call the sweet spot for Alfa Laval, which means that the certain ship classes are not so important for our order intake volumes.

And looking into 2021, if you take the Clarkson forecast on the ship classes that matters most to us, we see a positive development compared to 2020. Now there is a bit of delay in terms of order intake and of course, of invoicing, if you look at those contracting area. So it's not an immediate boost by any means, but it still is reflecting a situation where we are right now, which we

believe is at the bottom of the cycle. It's in the bottom of the cycle for Service. It's in the bottom of the cycle for contracting. It's in the bottom of the cycle for retrofit.

So in that sense, we feel a little bit proud that we can keep the results and the margin of the business together as strongly as we can under those circumstances. And I think if there is any sort of upturn possibility apart from sort of a weak global economy at the moment, that is probably in the marine sector.

Mattias Holmberg: And perhaps as a follow-up on that. We've been hovering sort of below the 1,000 mark in terms of number of vessels contracted for a couple of years now. In order just to understand the potential better, what would you say long-term average would be in order for the market to balance?

Tom Erixon: Well, it is – I may not be the prime source for forecasting the Marine market as such. But – and you're not quite right in your question. We've seen contracting levels between 1,000 and 1,500 ships even after 2016, where we had the other bottom level at 800, 850 ships wherever we were. I think if we look at the historical leverage of just above 2,000 ships, I think there are good reasons and good trend analysis to say that we may not see an average of – on that level in the future.

I think we've been using a number of 1,500 as maybe a better assumption, given the fact that world trade is not growing at the same pace any longer than it has been for a period of time. And average ship size is bigger today than it was in the past. So we cover a bigger growth number with fewer ships than we did historically. So I think compared to – currently, we are looking at maybe 800, 900 this year when everything is done and said or something in that range. So obviously, there is a volume increase opportunity going forward.

Operator: Our next question comes from the line of Max Yates of Credit Suisse.

Max Yates: Just my first question is on the cost savings that you booked this quarter. Would you be able to give us a feeling of whether any of the divisions disproportionately benefited from the savings? Or should we assume they were relatively evenly split across the divisions?

Jan Allde: Yes. It's Jan here, I can answer that question. It is pretty evenly spread across the divisions.

Max Yates: OK. And just a quick follow-up. So you talked about saving SEK 650 million to SEK 700 million temporary savings this year. I know you'll talk about the larger program at Q4. Do you envisage a scenario where these temporary cost savings coming back into the business can be largely offset? Or should we be thinking about sort of Alfa Laval's program that we've historically seen, which are closer to the sort of SEK 200 million to SEK 300 million kind of range? So I guess just understanding, do you think you can fully offset the temporary savings with a structural program?

Tom Erixon: Well, it's going to be too relatively different things. I think what you've seen from Alfa Laval historically has been a little bit of an average downsizing addressing global sales force and global R&D spend. I don't think that's where we're going this time. We are very confident in large parts of our portfolio when it comes to both margins and business opportunities going forward.

So that's why we've been so focused on doing flexible cost adjustments in this uncertainty period. We keep our sales teams and R&D teams and the technology teams very much intact, and that's our intention going forward as well. We feel we have a considerable strength in our core businesses at this point in time and a good momentum.

And I think the clearest sign of that is what you've seen in the Food & Water Division for the quarter. So we're going to be much more surgical and much more addressing the volatility that we've seen in parts of the Energy business and parts in the Marine business. So that's why we are moving into more of a structural program.

I had a hard time right now to be precise about how we would balance the two of them together. I think it's reasonable to expect that although, of course, we will see cost inflation coming into next year, that some of the more efficient ways of working related to digital tools and travel restrictions, we're going to carry some of that with us certainly into the beginning of next year as well.

So – and with that said, we will also have a little bit of time in some of the structural adjustments being made. So we will need to phase-in and phase-out. I mean we are obviously margin focused, but it's difficult for us to give a very precise guiding at this point in time in terms of how it will play out quarter-by-quarter.

Jan Allde: And remember as – maybe one addition. We – if you look at the total number of employees where we are today versus year-end and last year, we are about 500 to 600 less. So some of that cost has already taken place, yes.

Max Yates: OK. And just a very final question. On Food & Water, you obviously referenced some large orders in the guidance. Are these pretty broad based? Or are they – are you seeing them in kind of particular subsegments, whether it's Waste & Water, brewery, dairy, food, maybe sort of if you're seeing those specifically picking up in any area, that would be helpful?

Tom Erixon: It's – I mean, let me give – I think when it comes to large orders, that holds true across the board a little bit. The CapEx decisions are taking a little bit longer time. And we see that even for orders that are already signed, where we're waiting for down payments. And we see the lead time from signature to down payment being a bit longer. And as you know, we don't book any orders until we have a down payment.

So in that sense, the magic date before the quarter's end can be a bit uncertain on these products. So that's true in the Energy sector and, to a degree, the Marine sector as well. So it's not the food-specific side.

If we look at the Food portfolio, though, in general, I would say that the 2 areas where we did expect some weakness and maybe didn't see it as much was in the brewery sector, which is clearly affected by the weakening of the bar and restaurant business. And we have also expected a declining situation in the dairy side. And both of those, although a bit weaker, have held up a little bit better than expectations.

In other areas, we went as we did expect. We see good demand growth at the moment in veg oils. We see good demand growth in proteins. And we see very steady growth in our biotech and pharma industry. So all in all, it is a

stable to positive situation in the Food & Water Division going in. However, the large orders are coming in Q4, Q1, the underlying sentiment is positive for the division.

Operator: The next question comes from the line of Johan Eliason of Kepler Cheuvreux.

Johan Eliason: This is Johan. Just coming back to the Marine a little bit. I understand that part of the weak order intake or contracting is sort of an uncertainty among shipowners, what fuel they should choose in order to comply with emission standards 2050 target, et cetera.

If we look at the alternatives out there, I understand the ship class like LNG carriers are important for you. But if you look at the general ships out there, is there any fuel alternative that would be sort of more positive for you than another? I mean, if it's LNG, if it's LPG, if it's ammonia, if it's hydrogen and whatever you invent out there?

Tom Erixon: Yes. It's a good and somewhat complex question. Our analysis that we've done is that we are relatively fuel-neutral. So there are plus and minuses from an Alfa Laval portfolio in all of those scenarios. So we don't see it as a mega change in terms of overall business for us. However, it does obviously potentially affect the mix of products that goes into the engine room.

I would say that the one area that we see – let me make 2 comments to what we see in the market. Number one, although LNG probably looks as one of the more relevant and likely scenarios for increased fuel on board, at the moment, the majority and large share of fuel solutions for order ships continues to be traditional heavy fuel oil. And so there's – it's not a big difference at the contracting mix at the moment. And that is a safe play in terms of ensuring availability and still being able to comply with whatever regulations with the technology is available. I think that's one – statement number one.

Statement number two is that the one area that we do see and that I think is, to a degree, beneficial for us, but also for shipowners flexibility is that we see multi-fuel solutions. And multi-fuel solutions requires a little bit of more

technology in the engine room. We are certainly there. And certain product group does affect us in a positive way, not necessarily from volume, but from – in terms of our competitive position. So I think those are the 2 main trend comments I can give you as guidance.

Johan Eliason: OK. Then just was a bit curious about your cruise exposure. Didn't expect it to be a significant part of it. But roughly how big of your trailing Service business in the marine is related to cruise, is it 5 percent or 10 percent? Or what are we talking about?

Tom Erixon: I mean, you're right. It's a bit more visible because the fair share of the world cruise fleet is related to North America to the Americas region. So it is – and the Marine business in North America, other than the U.S. Navy and some other specific areas, is relatively high for our U.S. organization. So in that sense, it becomes a little bit regionally visible.

But as a guidance, I think our Service revenue in the cruise sector alone is down 8-ish percent for very good reasons. It doesn't really drive more than a few percentage terms out of the 10. I would say the bigger part that we see in the Marine service is our ability to do refurbishing work and on-site work on board ships where we see a relatively big decline. And as I said earlier, on the spare part sales, reflecting that most of the world's merchant fleet is operating normally, this spare part sale remains reasonably stable year-to-date numbers.

Johan Eliason: OK. Good. And then just one final question coming back to Klas' question a little bit about alternative scenarios if Neles does not come through, the sort of active pipeline, you talked about deal flow, et cetera. Is that big enough for you to sort of think that, that's the main use of your excess capital? Or if the Neles deal does not come through, should we expect anything extra to come back to shareholders?

Tom Erixon: No. I think I don't have any changed guidance when it comes to dividend policy. We've been stable throughout the decades on that. And I think that remains in place. We sort – it's a little bit tough to take the question of alternative to Neles. We are very focused to close the deal. We were positive. We expect it to come through. And we see it as a very important step for us

into industrial flow. We are very positive and hopeful from the fact that Neles Board recommend – continues to recommend the deal, and we see positive reactions with a lot of shareholders we are involved in.

So let me at the Capital Markets Day come back to what other options is needed. But my main focus now is to build the lead flow in the industrial flow together with the Neles team in terms of how we need to grow that business going forward together.

Operator: Your next question comes from the line of Andreas Koski of Nordea.

Andreas Koski: I have a question on the Food & Water margin, which was very strong. It's never been about 17 percent before, 17 percent before and now it was 19.4 percent. You are referring to mix effects. So could you please elaborate a bit on what was the positive mix effect in the quarter? And do you see that positive mix effect also in your backlog?

Tom Erixon: Yes. When we – I would make an overall comment to the Food & Water margin development, that is less quarterly specific and more general over the last few years. You know, those of you who have been with us, that we commented a number of times on the improvement on the quality side in the division.

And a trend shift that we have been seeing in the Food & Water Division from years back, and it's present in the quarter, it's present in the year, is that the number of large engineering orders in the food system side is decreasing as a percentage of the whole. We are driving the equipment business and the modular business, the configured product, as we often call them, in a stronger way and in a stronger growth way than we do for large engineered projects.

When it comes to the large engineered projects, we've been increasingly selective. We've been increasingly defining the areas where we want to appear as, call it, contractors as opposed to technology providers. And we have over the quarters and over the years seen the positive effect on that. That is partly a mix effect because we do have a better margin on equipment than we have on large projects. But it is also a quality effect that we have less deviations, post-

COVID deviations or claim situations with customers where we have some running in problems of installations that sometimes is creating problems for customers and for us and for other contractors involved.

So I think that's what I'm saying that having started from a minus 15 percent margin business in 2016, we feel comfortable that we brought it above and beyond the plus 15 percent corporate target. Then in the quarter, sometimes things go very well, and sometimes you have a bit of headwinds. So we thought that we were getting ahead of ourselves a little bit when the margin came in as strong as it did at 19 percent-plus, but it doesn't take away from the long-term improvement trend that I think is related to, let's say, a little bit of the mix question that you are addressing.

Andreas Koski: Yes. Understood. Very helpful. And talking about the backlog mix, could you also discuss the backlog mix in the Marine Division. Do you see the scrubber sales will come down further in the coming quarters? Or are we on balance now with where the order intake level is? And will you see ballast treatment system sales increase in the coming quarters? And what about pumping systems?

Tom Erixon: Yes, that was a lot of questions. I am not sure if I capture all of them. The – I would say over a little bit of a longer period of time, we don't see a big change to the pumping system business per se. So I will leave that with – but there are, as you know, quarterly variations on that. And sometimes – if you remember a couple of quarters back when we had – were weak on that and on scrubber at the same time, it was a big – considered a big event. But in fact, it comes and goes a little bit with the quarter. So the trend line for that is not so distinct.

It's different in terms of the environmental applications. I think largely, we have to say that the scrubber business is probably down towards the level where we expect it to be for a while. It's a relatively small part of our portfolio now. So obviously, when we compare to the running rate on order intake 18 to 15 months ago compared to now, a big part of the delta is the fact that we've gone down on scrubbers, whereas other parts of the portfolio have been strong.

The ballast water was probably affected a little bit this quarter in terms of the retrofit business and slowing, and some shipowners will go for their 5-year dry docking with a year's delay just because it's so difficult to get the supply lines to work for service and service engineers at the moment. So I think we saw a little bit weaker ballast water business than we expected, whereas the scrubber is low and probably reached the bottom of where it's going to be.

Andreas Koski: Understood. And then I would like to come back to the restructuring program that you plan to present in Q4 as well because you are saying that the temporary cost savings that you have had, a large part of that, as I understand, it will come back as cost in 2021. And we are seeing a declining backlog. So it looks like your sales level will be lower in 2021 than in 2020, of course, it depends on the pace of the recovery, but it looks like it will be lower right now.

So did you – or can you give a clear answer? Do you think you will be able to take out more cost than you expect cost to come back from temporary savings in this year?

Tom Erixon: Well, we were trying to address the question, Andreas. And I think I will remain a little bit vague on it, not because I'm positive or negative on it just because how things will play out quarter-by-quarter here is a little bit uncertain.

I'll go back to Jan's comment first. We are, at this point, 500 to 600 full-time employees lower compared to 12 months ago. So we are obviously moving in with – in a lower – and it's relatively substantial already that. If you remember, the restructuring program we launched in 2016, I think, covered around 1,000 people. We went from around 17,000 to 16,000 in a fairly big restructuring program.

Now this year, we moved down 500 to 600 without making noise about it, without launching any restructuring programs, just being cautious and adjusting capacities in a flexible way. So that side of the cost equation makes us be – and that's why I'm saying that despite the fact that invoicing is going down, we actually see positive productivity development during Q2 and Q3.

I commented on that at the last quarterly call, it is actually the first time in my industrial career over 20 years that I see positive productivity development when volumes go down. I actually think it's not necessarily because we are Nobel Prize winners in productivity.

But as you know, we've been running fairly large footprint programs and investments into our production system over the last year with elevated CapEx levels. And as we pull back on those and have those materializing with a few of them left now coming into Q1 next year, we're actually getting some benefit of that, that very timely is coinciding with the downturn.

We are still, as I think you know, in the final process of closing the Copenhagen manufacturing side with the move to Krakow, and there's some other things going in. So even with the programs that we've been running up until now, excluding the next restructuring program, I think we are adjusting our cost base fairly well, not only in terms of short-term flexibility, but also adjustments that will carry into next year.

So maybe that is the color I want to give you. I mean, we are very aware about where it's invoicing going and where it's cost going. So don't think that we are overlooking this question. You have a fair question. I just want to be cautious in my guiding in terms of how everything will play out here in the (inaudible).

Andreas Koski: Could I ask a last question on the Energy Division. I don't know if you have looked into it, but it seems like the EU is planning to fuel the recovery through a renovation wave to improve energy efficiency in buildings. And as I understand, it can be quite big amounts spending there. So my assumption is that you should benefit from this. But I wonder if you have a view or if you have looked into this?

Tom Erixon: Yes. I mean, I would say like this, if you look at the Chinese 5-year plan and the Chinese recovery when it comes to the Blue Sky's project as well as the EU's Green deal, those megatrends are certainly playing along the alley of driving energy efficiency in investments, in CapEx decisions that is well in line with the product offering that we have. We have from a public affairs

policy for a long time argued that energy efficiency as a contributor to dealing with the climate target is exceptionally important. It's very cost-efficient compared to a lot of the other initiatives that is being driven. So we believe that this is a way to go forward.

We see that in demand. If we look at the end markets related to both air conditioning solutions, but also in terms of heat pumps and other efficiency measures, we see a very firm and steady demand growth in these areas as well as increased technology investments into those platforms that we have been going through and are going through.

So I subscribe to your view without necessarily putting it down to an astronomical jump in demand, but it underpins, let's say, the long-term mix change that we are seeing, are facing and that you are seeing in terms of resilience in the Energy Division despite the weak oil price.

Operator: Your final question comes from the line of Andrew Wilson of JPMorgan.

Andrew Wilson: It's a kind of broader one around the portfolio, really. Obviously, in the statement, you talked about the restructuring changes you're looking to make and having identified sort of parts of the portfolio, I guess, where you need to take some action.

I just wanted to ask, sort of following on from recent years where we've seen some divestments. Interested as to, is if that's a route potentially for some of these product lines or parts of the group where potentially, that would make more sense as you kind of transition the portfolio.

I appreciate you've been investing in new products and perhaps you could sort of transition a bit more quickly by, I guess, sort of divesting some of the areas which might look less attractive either post-COVID or maybe even before COVID. Just interested in how – if that's the thought process that you're going through?

Tom Erixon: It is, to a degree. I think we said, as we concluded the greenhouse project, which was a very transparent way of dealing with some of the portfolio issues

we had at the time, we said that portfolio pruning will remain part of the daily job in our portfolio. And obviously, since we are driving our CapEx into a certain – to a degree, a different focus and driving a mix change in our group related to that, there are potentially some assets that are becoming less core.

I don't believe that it's going to be a major accelerator of the mix change. I still believe that when it comes to the energy side, although, we've said for a long period of time that 10 years from now, we're going to be different and the structural decline we see in the fossil side, we expect more than will be compensated by the positive demand trends in other areas of the Energy business. I think we shouldn't overstate the death of the oil and gas industry at the moment.

There is a big fundamental demand left in the oil and gas sector. We see continuous investment in petrochem in China and in some other markets. So I don't want to overdo the migration away. We have a customer base and the business and the commitment and the Service business in these areas. So I think we will see it continue. And I expect we have another upturn in that business before maybe we see a more long-term structural decline in that area.

But it may trigger the one decision or the other in the portfolio, nevertheless. And so I think the question is relevant. It's not going to be a huge transformation, but it may do some further steps in the mix transit that is, from a margin point of view, positive and from a mix long-term growth perspective, also positive.

Operator: Your final question comes from Sebastian Kuenne of RBC.

Sebastian Kuenne: Just quickly, the restructuring that you announced early February, would it be fair to assume that it relates to the segments that show the weakest order performance and where you see the slowest recovery, i.e., Marine, would you say that the restructuring would be 80 percent Marine related and then 20 percent others?

And then just as a follow-up, when you speak about sweet spots in the ship contracting sector, if you had to rank the ship types in terms of your inputs, would you say LNG, LPG comes first and tankers and containers and others?

And how big is the difference between, let's say, an LNG ship and container vessel in terms of content?

Tom Erixon: I mean you're absolutely right that we will target weak spots in the portfolio, and certainly, some of them are in Marine, some of them are in the Energy side. And as you can obviously see from the numbers, relatively few are in the Food & Water side. So I think 80-20 is overstating it. But there is a skew towards those 2 divisions for sure.

Regarding the ship mix, I don't want to go too detailed because there are variations on the theme, depending on – it's not only ship class. There are many aspects in terms of how shipowners want to equip their ships that affects our number of invoicing. But to take the 2 extreme points that we sometimes discuss, if you go to the bulk carriers, we sometimes say that our invoicing opportunity or business opportunity for those vessels are EUR 1 million to EUR 2 million, whereas if you go to an advanced cruise ships, we may be in the EUR 10 million to EUR 15 million range, and you can block the rest of it there, in between those 2 numbers.

Our sweet spot when it comes to tankers, containers, product tankers, cruise and all of that is fairly clear in the market. What's positive at the moment is if you look at the freight rates, the way they developed during this year, there's been periods at least, and to a degree, even currently, pretty good conditions for shipowners when it comes to tankers as well actually lately for containers.

So the business climate for the shipowners in areas where we are active hasn't been all that bad this year compared to where it was partly during last year and the beginning of the year. So that – I think that is partly underpinning the Clarkson forecast when it comes to the development of our sweet spot when it comes to 2021.

Sebastian Kuenne: So would you say that the 100 ships that Qatar wants to order in South Korea, the 100 LNG ships, does it make a big impact for you? Or is that kind of a rounding error in your business?

Tom Erixon: Well, I think, to a degree, Qatar will make a major place – a big contracting order with the shipyards in Korea, they also have to decide on what equipment makers do want to put on board. So I don't take anything for granted when it comes to demand. But obviously, in the global contracting market, which this year is going to end up at around 800, if there is an order floating around for 100 advanced ships, that is a fairly meaningful part of the global demand situation. So yes, it's obviously something that we would be engaged in for sure.

And with that, thank you for joining the earnings call. We will, as most people, unfortunately, have our Capital Markets Day in a digital format. It means it will be shorter, more concise. Nevertheless, I hope it will be a good session.

And with that, I hope that in a year's time, that we will have an opportunity to invite you to one of our facilities where we have driven development and CapEx and technology a lot over the last couple of years. So I hope we have a chance to meet physically in 2021 Capital Markets Day. But for now, let's take it digital. I hope to speak to you in November.

Thank you very much.

Operator: Thank you. That does conclude our conference for today. Thank you all for participating. You may all disconnect.

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