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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the SKF Year-End Report 2022. My name is Charlie and I'll be coordinating the call today. [Operator Instructions]

I will now hand over to host Patrik Stenberg, Director of SKF Group Investor Relations and Mergers and Acquisitions. Patrik, please go ahead.

Patrik Stenberg

Director-SKF Group Investor Relations and Mergers & Acquisitions, SKF AB

Thank you, Charlie, and good morning and welcome to all of you listening to this webcast.

This is, of course, the SKF conference call on the fourth quarter results. And as usual, we will start with a presentation followed by Q&A. Presentation will be initiated by Rickard Gustafson, our CEO; followed by our CFO, Niclas Rosenlew. After the presentation is over, we will continue with the Q&A session. And you are happy to post your questions over the phone as directed by the operator or you could use the chat function if you prefer that.

With that brief introduction, I will leave the word Rickard, please.

Rickard Gustafson

President, Chief Executive Officer & Director, SKF AB

Thank you very much, Patrik, and a warm welcome everyone to this webcast related to our fourth quarter report.

And I would like to start by looking back at the full year of 2022. We deliver a strong organic growth just above 8% which take us to the top of our previously guidance for the full year. Our adjusted operating profit came in at SEK 10.2 billion, representing an adjusted operating margin of some 10.5%.

I think we should see or view our numbers against the backdrop of a very challenging external circumstances throughout the year. We have the war in Ukraine and all the consequences thereof, including our exit of our business in Russia. We have had and lived with an exceptional cost inflation levels. It has been a moving target for us throughout 2022, but we're happy to see that the gap is now closing towards the end of the year and you will hear more about that in this presentation. And, of course, we also have experienced significant lockdowns from the COVID restrictions in China for a rather lengthy period of 2022.

But the year of 2022 was also the year when we accelerated our strategic agenda. We have capitalized on our growth opportunities and delivered double-digit growth in most of our targeted industries. We are taking a more active approach to portfolio management to improve our operational performance. Our technology initiatives are progressing well and I will share more details later in this presentation. We have further accelerated investments in our regional engineering and manufacturing capabilities to enhance our competitiveness, and I'm going to share some examples of that as well during this presentation. So, all in all, we have established a strong foundation for 2023.

If we then take a look at the fourth quarter in isolation, net sales maintained very strong in the quarter and came in north of SEK 25 billion representing an organic growth of approximately 10%. Roughly two-thirds from this growth comes from price/mix and one-third from volume. The adjusted operating profit was SEK 2.5 billion corresponding to adjusted operating profit of 10%. This represents a sequential profitability uplift versus Q3 but not yet at the level where we want to be. And the main reason for this is still the cost situation that we have a rather high cost inflation even though it starts to level out and I'll share some more details on that shortly.

In this quarter, we have somewhat of a different business mix than normal where automotive has contributed with some rather large growth of 12%. And then, we ended the year in China with some exceptional sick leave rates after they lifted the COVID restrictions in China and basically in most of our people then ended up being out of sick leave during the month of December.

But net cash flow for the full quarter was very strong; it came in at SEK 3.4 billion compared to SEK 1.2 billion the same quarter last year and this is primarily related to activities within networking capital that we have conducted during the quarter, and you will hear Niclas talk more about that shortly.

All in all, we saw strong organic sales growth as well as sequential price realization in the quarter, supporting an improved adjusted operating profit versus previous quarter but also versus the same quarter last year.

If we look into our growth activities and again, I'm very pleased to report strong progress on all our four core growth levers starting with the industries. In the quarter, we saw strong double-digit growth across most our targeted segments. And as you can see on the right-hand side of this chart, see that electrical vehicle stands out with a significant growth of 46% in the quarter but also a number of those industries that we also highlighted in our Capital Markets Day in December continued to deliver solid double-digit growth, such as agriculture, and food and beverage, and rail, as an example.

When it comes to new technologies, strong progress there starting with magnetic bearings, solid growth, partly driven by energy application, an area where magnetic bearings really have a role to play. And we're also pleased to see that they report a record order intake in 2022, reaching north of SEK 1 billion for the first time ever.

RecondOil continues its strong progress, significant interest in the RecondOil books. But now, in this quarter, we also started to operationalize some new strategic partnerships such as the one with Quaker Houghton and Castrol, which we are excited about.

We continue to expand our service and aftermarket business and our distribution business grow by 10% in the fourth quarter. In relation to this, we have renewed our focus on condition monitoring, where the responsibility for connected technologies have moved closer to our customers by being distributed to our business areas.

And finally, on portfolio management, we continue those tactical and strategic activities that we described in detail at our Capital Markets Day in December. And we have commenced on the strategic review of our Aerospace business as we also announced back in December.

Moving on and taking a look at our pricing activities, we continue to increase prices and prune our portfolio to further strengthen our business and market position. Our efforts have resulted in another quarter with a growing positive price/mix contribution. And as you can see from this chart, in this quarter, we have a positive contribution of SEK 1.8 billion from these activities. However, though, cost inflation is still an issue that we're wrestling with, and even though it's moderating and leveling out, it's still at a high level and we've had headwinds of roughly SEK 1.8 billion Swedish in the quarter; of course, a significant drop versus what we had in Q3 last year.

So, also what's obvious on this chart, after five consecutive years of negative price/mix inflation balance, now, the bars of evenly starting to finally even out. This is, of course, a positive data point, but it's a bit premature to call it the trend.

Now, if you take a deeper look into our Industrial segment, we saw a very strong organic growth across our Industrial businesses at around 9%, roughly 50/50 split between price/mix and volume, but also which is obvious on the slide, it's not even a distributor across our geographies. We saw very solid growth in Americas coming in at some 6% with strong performance in automation, material handling and agriculture, to mention a few.

The organic growth in EMEA was actually surprisingly strong at 13%, with very strong growth in aerospace, rail, marine, and agriculture as well. We see a strong and continued momentum in India and Southeast Asia, where they're growing 16%, mainly from wind, rail, off-highway, and heavy industries. While finally, China and Northeast Asia is more flattish or moderate organic growth, also heavily impacted by the COVID situation at the end of the Q4 in China.

If we look into the Industrial business and the financials a bit further, the adjusted operating margin came in at 12%, this is due to the good pricing momentum that we have in our industries, and we are able to better balance the cost inflation. That has enable us to deliver an adjusted operating profit that is actually on par with what we saw the same quarter last year at SEK 2.2 billion.

And we're excited about that. We see that we our ability to really deliver tailored and specialized solutions to our customers provide true value and enable us to continue to drive profitable growth. I'd like to bring two examples to life today, starting with one that is derived from our sustainability capabilities that is becoming a major differentiator in our offerings. And here, I'm going to bring your attention to an example where the contract that was signed with a mining company in Latin America. And my second example relates to application-specific offerings where we have been able to sign a contract also within the elevator industry.

But let's start by taking a look then at the sustainability related example, sealed spherical roller bearings is a great example of what SKF support industries to reduce CO2 emissions. We recently delivered a sealed SRB solution to a mining company in Latin America. And as you can see from this slide, these are not small bearings, they are massive. They are 2.5 meters in diameter and weigh about three tons a piece. But the key customer value is that the sealed SRB solution brings to our customers is threefold.

Firstly, from a cost point of view, these bearings, they have a superior service lifetime, at least 2 times versus traditional open SRBs. The environmental benefit is also rather significant. They enabled us to heavily reduced the grease consumption. And as you can see from the slide, in this particular case, the annual consumption dropped from 540 kilograms to only 70 kilograms, a massive transformational shift. And finally, circular economy is starting to become more and more important. And these bearings, they are designed for remanufacturing possibilities, adding another dimensional value to our customers.

And finally, I'm also pleased to say that in order to win this business and win this contract, we were also able to leverage our recent acquisition at the back end of last year of Tenute and their capabilities and technologies helped us to finish off and sign this deal.

Moving on to my application-specific offering example and relating to the elevator business. SKF is the leading supplier in the elevator segment with a strong and growing market share. We are gaining market share due to our outstanding quality, but also due to our application-specific offerings in this particular industry. And what we mean by application-specific offerings is when we design solutions to fulfill specific customer performance requirements related to cost, noise, vibration, or friction.

In this case, when we signed or renewed, I would say, a major contract with a large OEM in the elevator industry was really due to our ASO capabilities. In this case, the customer had a clear requirement on us. They needed us to significantly reduce the cost of the bearings for them to stay competitive. Our engineers took on this challenge and come up with a solution, where we created a product with reduced number of rollers and optimized ring material and new lubrication system.

As a result, we were able to deliver the price expectation to the customer. The bearing itself came with lower noise, which was an additional benefit to the customer. And also, from an SKF point of view, this enabled us to significantly improve our operating margin on this particular contract.

So through ASO activities like this one that I just described, we are able to drive profitable growth across many of our industries.

So now, I think it's time to turn to our other area, our automotive business. And like for our Industrial business, we see strong organic growth in the quarter of roughly 12%, and this time it's primarily from price/mix.

As for the industrial side, it's not evenly distributed across our geographies. You see continued and strong growth in the Americas, reflecting very strong growth in light vehicles. In EMEA, organic growth is very, very significant at 19%, where – coming from primarily commercial vehicles growing some 25% and light vehicles growing some 20%, 21%. India and Southeast Asia grow also solidly at 12%, primarily driven by light vehicles in this area. And then, China, flattish. And again, the COVID outbreak at the back end of 2022 is the main driver behind the rather weak growth performance in that region.

Going further into the financials of automotive. We delivered an operating profit of SEK 400 million, corresponding to an operating margin of 5.4%. This is a significant sequential improvement versus Q3 and also versus the same quarter last year. And this is primarily due to the positive price contribution that we are able to achieve, both from the OEM market and the aftermarket.

And as you all know, we are on a transformational journey to transform our automotive portfolio. And in the fourth quarter, we have signed some contracts that will enable and further accelerate this transition. We have signed major contracts with large commercial vehicle OEMs, both in Europe and Asia, really creating an even stronger foothold for us in that particular segment, large commercial vehicles, which is of strategic importance to us. And we also signed high volume agreements for ceramic bearings with two Asian EV producers, again, strengthening our position in the important EV area or EV segment.

And speaking about EV, to support this significant growth that we see in this segment, I mentioned 46% in the fourth quarter, close to 60% for the full year, we must and we will continue our regionalization efforts. And to bring this to life, I'm going to share one example today where we now announced an investment of roughly SEK 700 million to build a greenfield operation in Monterrey, Mexico. This plant will provide bearings both for industrial and automotive applications, supporting the growing demand from electrification. The investment will improve our localization rate and thereby enhance our overall competitiveness and flexibility to support customers in Americas. And the first channels will actually open already in the mid-2023.

So that ends my introductional remarks to our numbers, and I'm now going to hand over to our CFO, Niclas, who will take you through some more details.

Niclas Rosenlew

Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

Thank you, Rickard, and hello, everyone. So let's take a closer look at the financials, starting with sales. So in Q4, our net sales was SEK 25.4 billion, quite significantly up from last year at SEK 21 billion. Our sales grew both sequentially and compared to last year, driven by a pretty broad-based demand from multiple industries and from multiple product segments.

If we look at the sales bridge, compared to last year, our sales increased by 20.9%. The impact of the Russian exit was a negative 1.8%. And as a reminder, we exited our Russian business back in Q2 2022. The organic sales increased by 9.7%. And as Rickard mentioned, one-third being volume and two-thirds being price/mix.

The currency effect on sales was positive at 13%, with the largest effect coming from the dollar, the renminbi, the Brazilian real, and the euro. So all in all, a very strong sales performance.

Moving on to our operating profit. Our adjusted operating profit was SEK 2,542 million versus SEK 2,260 million last year. And overall, we continue to have a good momentum in price/mix, which compensated for the higher cost in the quarter. What comes to cost? As Rickard mentioned, we did see some moderation of inflation, but costs are still at the high level. So, if you go through this step-by-step, firstly, the currency impact was positive at SEK 148 million compared to last year. And here, while the strong dollar contributed to higher sales, as we just discussed, we have a relatively high portion of our costs in euro resulting in a more limited benefit on our profits from effects.

The Russian business was divested as discussed, and this had a negative impact of SEK 11 million in the quarter, meaning that we had a profit last year which we did not have this year. Our organic growth, which is volume, price, and mix, contributed with a positive SEK 1.9 billion. Out of the SEK 1.9 billion, approximately SEK 1.8 billion, so the vast majority was price/mix and the rest was volume. And as we've discussed, the price/mix continues to develop or continued to develop favorably throughout the last few quarters. And if we go back in time, a year ago in Q4, so in Q4 2021, it was SEK 700 million then SEK 1 billion in Q1, SEK 1.3 billion, SEK 1.8 billion in Q3, and now we had roughly SEK 1.8 billion in Q4. These being year-on-year comparisons.

Then moving on to costs. The total impact from costs, so higher costs was SEK 1.8 billion, which is roughly equal to price/mix. What comes to cost inflation, just to give you a bit more flavor, it did moderate somewhat in Q4 from the very high levels seen in earlier quarters. It's a bit of a mixed bag with material costs still high but we did see some moderation. For logistics, we've seen costs actually start to come down. For energy, we did see some moderation, actually costs coming down somewhat during the quarter. On the other hand, salary inflation impacted the cost picture negatively, i.e. increasing salary inflation.

As previously stated, we are working on offsetting inflation and higher costs with price/mix over time. We are pretty confident we'll get there. And in Q4, this was the case. What comes to other parts of cost management or cost management in general, as you know, in connection with Q3 results, we launched a SEK 2 billion cost reduction initiative. We worked on this during Q4 and as a consequence, we had approximately SEK 400 million in restructuring costs and expect the benefits then to come gradually throughout 2023.

So, to sum up, we had a continued good momentum with sales, with price and mix and moderating all those still high cost levels.

Moving on to cash flow, we generated a net operating cash flow of SEK 3,350 million in the fourth quarter compared to SEK 1,231 million last year. A driver for this strong cash flow was working capital, which turned positive in the quarter after having been negative throughout 2022 or prior quarters in 2022. Net working capital as a percentage of sales decreased to 32.4% with inventories sequentially down and a positive contribution from receivables. Also worth mentioning that we have seen some normalization of supply chain bottlenecks throughout the quarter.

When it comes to net working capital, we continue to work on reducing it across all of our businesses. And here, there's no quick fixes, really but we are confident that we'll start to see net working capital come down over time. So, all in all, a strong cash flow in the quarter.

When it comes to our balance sheet, it continues to be strong and our liquidity to be solid. The net financial debt amounted to approximately SEK 10 billion by the end of the quarter, which is a clear sequential improvement driven by the strong cash flow. In the quarter, we repaid a €300 million bond. And looking at the 12-month rolling return on capital employed, it stabilized and was 12.6%.

If we then turn to our outlook, looking into, specifically first, the first quarter of 2023, we expect mid-single digit organic sales growth. And then looking at the full-year 2023, we expect also mid-single digit organic sales growth compared to 2022. We do expect continued volatility and geopolitical uncertainty in the markets and as a result, we expect continued high levels of cost inflation and volatile demand.

And with that, I thank you and hand it back to you, Rickard.

Rickard Gustafson

President, Chief Executive Officer & Director, SKF AB

Thank you very much, Niclas. And before we go into the Q&A session, I also like to wrap this up and starting with the fourth quarter. We are pleased to report a sequential improvement of our financial performance in Q4 versus Q3. And for the full year of 2022, as I said before, the – we had a strong organic growth at 8% at the top end of our guidance and an operating margin of 10.5%.

Throughout the year, we have been operating against a backdrop of very challenging circumstances. But I do like to reiterate that 2022 was the year when we accelerated our strategic agenda. We're delivering double digit growth in most of our focused industries. Our technology initiatives are progressing well, as I described previously in my presentation. We are taking a more active approach to portfolio management to improve our operational performance.

We have also implemented a decentralized operating model, which is a significant cultural change in SKF. And we have accelerated our investments and regional engineering and manufacturing capabilities. Altogether, as we enter the new year, we are confident that we've built a strong platform for 2023 with a clear strategy for driving profitable growth while supporting a cleaner and more sustainable industrial development. And finally, our board of directors proposed a maintain dividend of SEK 7 per share, subject of course to AGM approval.

So, that ends our formal presentation. And I'm now going to ask Patrik to come back up and help facilitate the Q&A session.

Patrik Stenberg
Director-SKF Group Investor Relations and Mergers & Acquisitions, SKF AB

Thank you, Rickard and Niclas, for the initial presentations. And operator, with that, we are good to go for the Q&A session. So, please bring the first one on.

QUESTION AND ANSWER SECTION

Operator: Of course, thank you. [Operator Instructions] Our first question comes from Klas Bergelind of Citi. Klas, your line is open. Please go ahead.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.

Q

Thank you. Hi, Rickard and Niclas. Klas at Citi. So, great to see that you've now compensating the cost inflation fully. I'm just thinking about the first quarter. It looks like you will get a price/mix of around SEK 1.6 billion or a bit more than 7%, want to do stack pricing if nothing changes. That's down 2% on volume within the mid-single digit growth guide. You're now saying that energy, I think, was flat; logistics, a slight positive; raw mats negative SEK 900 million, around half of it of the SEK 1.8 million. When we think about these three components, Niclas, to what extent will they now turn positive in the bridge in the first quarter? It looks like you can get quite a solid margin here at the start of the year if you go positive across the board on raw mats, logistics, energy, I'll start there. Thanks.

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

A

Yeah. I mean, hey, Klas. The – as we know, I mean, the whole kind of cost picture or cost inflation is – has been a volatile mixed bag and I'm trying to predict now what's coming in the future. Well, we leave that to others. But, specifically, as you said, in Q4, we had – we did see, which is obvious from our bridge as well, we did see the cost levels coming down exactly in the areas that you said.

And, of course, if things continue as is, we should see kind of a further positive, kind of tailwind and lower cost levels. But exactly starting to predict which role within the cost is going up or down, we'll come back to that in the future when we have the results.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.

Q

Yeah. And I appreciate that. It was more like at the current level. And it looks like price cost can turn positive, all else equal, when I look at the bridge. That was more my point, but I get it...

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

A

Yeah. Yeah, I mean it – yeah, it absolutely, eventually that's what we are working towards also and want to see and as we saw now in Q4. It was evening out, so same level but longer term, of course, we expect and hope and work towards a positive gap there.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.

Q

And then for you, Rickard, a question on your mid-single digit growth guidance for the year. It seems like 3% to 4% pricing, if nothing changes within the mid-single digit growth. If I just drag out the current level of price/mix, is a little bit of volume growth, you typically have low visibility but industrial backlogs out there are currently solid and feeding into your demand. China is also likely to come back here from the second quarter. So, I'm trying to understand how you think about price/mix within the outlook and how you think about the demand picture, the volume outlook within the mid-single digit growth? Thanks.

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB

A

Right. Good morning, Klas. Well, as you know, we don't guide for price/mix but rather for the organic growth. And to give you some perspective, I think we come out of the Q4 with a rather good run rate and also a, as I said, a surprisingly strong growth in EMEA, while we were a bit disappointed in the – of the growth rate in China due to the COVID outbreak and the very severe sick ratio that we experienced in December.

And then, we look into the order book and what to expect. And our best guess is that we should be at around mid-single digit for the first quarter. And we do acknowledge that it's hard to predict the full year. It's a lot of volatility. It's a lot of uncertainty. But to your point, and as I also mentioned in my presentation, we do believe that China would be in for a rebound at some time during Q2 next year. That will then help to drive some of the growth going forward. So still, our best guess or our best bet is still around mid-single digit growth also for the full year with 2023.

Klas H. Bergelind
Analyst, Citigroup Global Markets Ltd.

Q

Thank you.

Operator: Thank you. Our next question comes from Daniela Costa of Goldman Sachs. Daniela, your line is open. Please proceed.

Daniela Costa
Analyst, Goldman Sachs International

Q

Thank you so much. Good morning. I have three things, if possible. One is follow-up, I guess, on the prior question. But just if we look at your Industrial business a couple of years back, 14%, 15% margin level. Since then, obviously, lately last year, you had like huge headwinds on energy and raw mats and you're still expecting very good growth going forward. Those headwinds, as you just mentioned, they may be easing out. Is there anything structural that would prevent you to go back, you think, to those levels, or is just the timing matter of these headwinds going ahead? So that's number one.

And then, regarding also – one point on a prior question regarding end demand and your confidence on the mid-single digit growth. We hear a lot of industrial companies talking about sort of reducing their inventories at the moment. So as you look through your customer base in terms of the inventory of bearings that they have, what do you see?

And then, a final thing, which is just more conceptually, just curious on the thinking behind on why do you guide on growth rather than guiding on margin when you guide Q1 and then full year? Just trying to think about sort of what you want to signal internally to the organization, given a lot of the things you talk at the CMD in December were more self-help cost-related improving margin. So just interested on the thinking there, if possible. Thank you so much.

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB

A

Thank you, Daniela and thank you for your questions. I'll try to address your first and third one. And then, Niclas, if you take the inventory one. Yes, you're right. We have, normally or historically, an industrial margin that should be at around 14%, 15%. And my answer to your question can only be that we are determined to further strengthen our profitability in our Industrial segment.

And we are not shying away from our long-term financial target, which is a 14% operating margin. And that's what we're aiming for and that will imply that we need to further strengthen in profitability in our Industrial business. I'm not standing here today to give you timing of this. I only can give you that you can rest assure that that's our ambition and that's what we're driving for, and we're not shying away from our financial targets.

On the guidance and growth. I think it's something that we are comfortable with, an area where we think we have a track record to give the market some confidence in our performance, and also our ability to predict the future also in a rather volatile environment.

But to your question, how we address this internally, of course, we have a significant emphasis on the key things that we addressed at the Capital Markets Day. Everybody is fully aware that in here we work on lifting our profitability. We're working on driving our portfolio management activities. We are obsessed with improving our network and capital activities. And we will relentlessly drive cost efficiency and productivity across our business. So we have our priorities clear internally, even though we guide for the organic growth rate, as we have done in for a number of years.

Niclas?

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB
A

Yeah. And maybe just to add, which I'm sure, Daniela, you know, but guiding on growth is quite in line with kind of market practice in Scandinavia and actually not too many, as far as I'm aware, guide on margins in Scandinavia. But anyway, just to add one more comment on the Industrial, I mean, there is nothing structural why we shouldn't and couldn't and will not get to where we were, 15%, 16%. Of course, our ambition is higher than that.

When it comes to inventories, for this reason, we are talking about it and many others, as you say. In general terms, we don't see an overstock out in the market, out with our distributors, for instance. So that's a short answer or short feeling or a view on the kind of inventory levels in the market.

Daniela Costa
Analyst, Goldman Sachs International
Q

Appreciate that. Thank you.

Operator: Thank you. [Operator Instructions] Our next question comes from Andre Kukhnin of Credit Suisse. Andre, your line is open. Please go ahead. Andre, your line is open. Please proceed with your question.

Andre Kukhnin
Analyst, Credit Suisse Securities (Europe) Ltd.
Q

Thanks. Thanks so much for taking my question. Could you please talk about the stocking and destocking decisions that you took during Q4 and how that impacted P&L? And then, what do you intend to do on that front in 2023, please?

Patrik Stenberg
Director-SKF Group Investor Relations and Mergers & Acquisitions, SKF AB
A

Right. Hi, Andre. On the stocking side, we have actually managed to reduce our net working capital in the quarter. And part of that comes from reduced inventories. So all in all, we have made – are able to reduce the volume of finished goods inventories to some extent in the quarter. On the contrary, last year, we actually built inventories to some extent. So we have a slight headwind in the bridge, on the operating profit to an extent of SEK 70 million-SEK 75 million, probably somewhere there.

Andre Kukhnin
Analyst, Credit Suisse Securities (Europe) Ltd.
Q

Great. Thank you. And so, for 2023, do you intend to take that down further?

Patrik Stenberg
Director-SKF Group Investor Relations and Mergers & Acquisitions, SKF AB
A

In line with our ambition for reducing our net working capital and the ratios, of course, inventories is one of the main levers in achieving those targets. So yes, we have an ambition to continue to drive inventories down.

Andre Kukhnin
Analyst, Credit Suisse Securities (Europe) Ltd.
Q

Great. Thank you. And if I may, just last one. In terms of that cost line swing around, and I apologize if this is a repeat. We're kind of on multiple conference calls at the same time. There was quite a swing, obviously, in Q4 versus Q3 and a substantial kind of moderation in that headwind. Could you, explaining that a bit? And then secondly, just in terms of the energy cost inflation that you've now incurred in 2022 versus where the spot prices sit. Does that now imply a tailwind for 2023 versus 2022 or a headwind? Or are we broadly equal with a very high Q3 than smaller Q4 and spot prices being kind of lower than that now?

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

A

Yeah. Hey, Andre, super relevant point, of course, your question. I mean, first of all, just to remind us, when it comes to our cost base, our – the biggest chunks in the cost is actually materials supply, general supply for manufacturing and then personnel, while energy is quite a lot smaller component in the overall cost. But anyway, I mean – and maybe then another general comment is that we are largely unhedged, whether it's energy or other things. Of course, we have contracts and so on.

But if you really, really kind of grossly generalize and look at the market, the spot prices and then ask when will you see it in SKF's cost base. Maybe it's six months, maybe six to nine months, four to nine months, something like that. But the point is that there's quite a delay. And we did see again a moderation in materials, which in our case is mostly components. Still high, but again, a slight moderation in the inflation levels, and the logistics cost actually came down in absolute terms somewhat. And then energy was actually pretty much at a similar level to last year. So those are just a few of the moving parts.

Then on the other hand, salary costs continue to go down – go up, sorry. So it's a bit of a mixed bag, but as you say, I mean, in the bridge, it came down quite significantly compared to Q3. And keep in mind that kind of delay from spot prices to when you see it in our P&L.

Andre Kukhnin
Analyst, Credit Suisse Securities (Europe) Ltd.

Q

Right. Thank you. Appreciate the time.

Operator: Thank you. Our next question comes from Erik Golrang of SEB. Erik, your line is open. Please go ahead.

Erik Golrang
Analyst, Skandinaviska Enskilda Banken AB

Q

Thank you. I have three questions. First one on China, on the sick leave, I don't know if I got you correct, that more or less, your full workforce was on sick leave in December. But anyhow, what was the – could you sort of quantify the profit impact from such a level of sick leave?

And then the number two and number three questions are on the new investment in Mexico. And the first question is, as I understand it, it will produce bearings for applications for both industrial and automotive. And how does that square with your ambition there to get to some kind of strategic flexibility when it comes to automotive, building a plant that will produce for both?

And then a follow-up on that one is, is it all sort of to shift production from other regions and to localize? Or is there sort of incremental business and customer rewards that will ramp up here as well, or is it entirely to replace existing business? Thank you.

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB
A

Thank you very much. Starting about China, trying to be more specific about the sick leave ratio there – sick leave ratio. What we saw when we started December, kind of December 1, I think we had less than 1% of our workforce have had – been infected with COVID. At the end of December, 80% of the workforce had either been – were either – impacted by the COVID and at sick leave or back from COVID. So roughly, I think, at the peak, we had 40% out from – on sick leave, and some people coming back from sick leave.

But, so it's kind of – basically entire workforce have been through the inflation – or sorry, the COVID during the month of December. And we are not unique. I think this represents kind of the society in general in China. So of course, this has a negative impact. And we don't disclose the actual number that this had. But of course, it had a negative impact because we could not run our operation in normal – at normal pace due to this, of course. But on the other hand, it seems to be the peak is now behind us and now, we're looking forward to 2023.

And on your question on the investment in Mexico, it is primarily that we – rather than that we do today import bearings to support the Americas market, this will be, you know, that we then shift it onshore to stay – reduce cost, and we increase our competitiveness and our, of course, also our profitability in that regard. While it also going to serve both automotive industrial markets, it's primarily an automotive factory, but some of those bearings, they also fit very nicely in some industrial application, so it makes logical sense to also produce it there and support some industrial applications in the EV space, so or in the electrification space. So it is an automotive factory but it will do provide some components also for industrial applications.

Erik Golrang
Analyst, Skandinaviska Enskilda Banken AB
Q

Thank you.

Operator: Thank you. Our next question comes from Andreas Koski of BNP Paribas. Andreas, your line is open. Please go ahead.

Andreas Koski
Analyst, Exane BNP Paribas SA (Sweden)
Q

Thank you and good morning. So firstly, on your organic growth guidance of mid-single digit organic growth in 2023. Could you please give some color on what you expect by division and by region?

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB
A

No. We don't break it down, Andreas, is the short answer.

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB
A

Yeah.

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB
A

I mean, as Rickard mentioned earlier, I mean, we do foresee, at least in the near term, a dynamic where China starts the year low and then bounces back. Also, as Rickard mentioned, I mean, Europe has actually been somewhat surprisingly strong. So let's see how long that continues. But so far, so good. So we don't really break it down.

Andreas Koski
Analyst, Exane BNP Paribas SA (Sweden)

Q

Okay. Understood.

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

A

Short answer.

Andreas Koski
Analyst, Exane BNP Paribas SA (Sweden)

Q

Yes. Then secondly, on the cost development line, what did the savings amount to in the quarter? And where are you in terms of run rate on the world-class manufacturing program and the recently announced fixed cost program?

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

A

Yeah. So world-class manufacturing, I mean, we discussed in the Capital Markets Day, the picture is pretty much the same. So we are SEK 2 billion out of the SEK 5 billion ambitions. So SEK 5 billion being the ambition by 2025. And we are at roughly SEK 2 billion now. What comes to the SEK 2 billion cost reduction program? There hasn't really been any impact – positive impact yet while we've started, as I mentioned, started to take some of the actions which then resulted in restructuring charges. So that's the kind of short overall picture.

Andreas Koski
Analyst, Exane BNP Paribas SA (Sweden)

Q

Okay. So it sounds like you didn't have any meaningful savings in the fourth quarter. Would you say it is fair to expect that cost savings will be at least SEK 2 billion in 2023?

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

A

No. The run rate exiting 2023 is SEK 2 billion. Correct. So it's significantly less that you'll see in the full year result 2023. But nevertheless, it will ramp up over the year. Yes.

Andreas Koski
Analyst, Exane BNP Paribas SA (Sweden)

Q

Yes. But I guess you will also have SEK 1 billion or so maybe coming from the world-class manufacturing program. So with total, that would take you to SEK 2 billion.

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

A

Yeah. Well, yeah. Fair.

Andreas Koski
Analyst, Exane BNP Paribas SA (Sweden)

Q

Yeah. Okay. And lastly, on the world-class manufacturing program, if volumes are not growing in 2023, do you think you will be able to step up the pace of factory closures?

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB

A

When it comes to factory closures, it's primarily a European issue for us where we have a legacy, where we have to think through long term, where are we and how we want to develop our European manufacturing footprint and supply chain.

And of course, if we end up in a downturn, that might open up for some opportunities to drive some of this. But I still think we have a little bit of a homework to do internally to really define what our end game should look like. And then clearly articulate a path towards that end game regardless of the economic development around us.

Andreas Koski
Analyst, Exane BNP Paribas SA (Sweden)

Q

Yeah. Okay. Very clear. Thank you very much.

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB

A

But so far, we are staying strong with those targets that we said though.

Andreas Koski
Analyst, Exane BNP Paribas SA (Sweden)

Q

Sounds good. Thank you.

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB

A

Thanks.

Operator: Thank you. Our next question comes from Lars Brorson of Barclays. Lars, your line is open. Please go ahead.

Lars Brorson
Analyst, Barclays Capital Securities Ltd.

Q

Great. Thank you. Good morning. One for Niclas, please, and perhaps one for Rickard. Niclas, I just wanted to clarify. Sorry. Just for – to avoid confusion. I think I heard you said price/mix of SEK 1.8 billion, so 9% in the quarter. I thought I heard Rickard earlier say two-thirds of the 10% organic was price/mix of 7%. So maybe just clarify that.

And on the SEK 1.8 billion cost line, so I had raws at SEK 900 million; the other SEK 900 million bucket, I think I've heard energy neutral, small logistics tailwind. I'm assuming wages, call it, SEK 350 million. So we're still missing SEK 400 million-SEK 500 million. It feels a bit like the last quarter where we had a so-called other bucket of a similar size that wasn't specified. Wonder whether you can, A, confirm those numbers? And B, give a bit of color around that other bucket? Thank you.

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

A

Yeah. So hey, Lars. Sorry, I'm not sure I got the question fully here. So in the operating profit bridge, we had a kind of a positive SEK 1.9 billion; and SEK 1.8 billion of that SEK 1.9 billion is price/mix. Let me know if it doesn't answer your question fully.

But then, on cost inflation, without digging into all the details, because I mean we tend to kind of simplify it and talk about these large buckets. But of course, there's quite a wide array of different types of costs going up and down within the overall cost bucket. So we were just trying to provide you an overall picture generalizing it, but then there's a lot of other ups and downs, other cost inflation also, you can get into a lot of details, but maybe that doesn't add to the big picture.

Lars Brorson
Analyst, Barclays Capital Securities Ltd.

Q

No, that's fine. But raws at SEK 900 million and energy neutral in the bridge, small logistics tailwind. Those are all fair assumptions, correct?

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

A

Yeah. Those are fair; and then, salary inflation.

Lars Brorson
Analyst, Barclays Capital Securities Ltd.

Q

Yeah. Clear. I think we can figure this offline. And maybe briefly, just for Rickard. The EMEA acceleration, a bit of a head scratcher, I think, at least for me. I think I also heard Niclas say let's see how long it continues. You called out Aero, I think Rail, Marine in EMEA. Wonder whether there was sort of any bigger framework deliveries in the quarter that might have swung it. And I also noticed your industrial distribution business is holding up very well in Europe. And so, maybe you could give us a bit of color as to what you saw in the quarter, and maybe what you see going into the early part of this year? Thank you.

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB

A

Now, I think I have to reiterate roughly what I said in my presentation, Lars. I used the word surprisingly strong because it was a stronger growth in EMEA than we anticipated when we entered into the quarter. We do see that in some areas, we do see that the activity is starting to level out a bit, for sure. And in some industries, like the ones that you mentioned, we have seen extraordinary strong order intakes. We are sold out in Aerospace, for example. It's a big back swim after the COVID implications for the aerospace industry. So of course, we now experience there significant growth rates in that particular industry. And also, Marine has been growing very, very nicely.

But we cannot ignore the fact that we see that companies more targeting the – or active in the B2C segment. They start to see this more and more tangibly in their business, an economic downturn. And in my logic, they will be the first one hit, and then B2B businesses will follow. So we watch this carefully and we are leveraging the opportunities that we have in the market. But we also are preparing ourselves for winter, if I may use that phrase.

Lars Brorson
Analyst, Barclays Capital Securities Ltd.
Q

Understood. Thank you both.

Operator: Thank you. Our next question comes from Sebastian Kuenne of RBC. Sebastian, your line is open. Please go ahead.

Sebastian Kuenne
Analyst, RBC Europe Ltd.
Q

Yeah. Hi, everyone. I would just like you to clarify that – your exit on profitable yields and contracts, as you have announced at the Capital Markets Day, and I was wondering if your guidance for Q1 and for the full year would include any of these exits. And maybe you can give us an idea of how big these exits are. That would be my first question.

And maybe straight away my second question because of time. Again, on raw materials, we know that iron ore and steel prices come down, but we also know that the contracts that you have with your suppliers, they are very much delayed when it comes to passing on energy costs and so on. Maybe you can give us a little bit more detail on what you see on the steel prices development at this stage. Thank you very much.

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB
A

Good morning, Sebastian. I'll try to answer your first one, and then Niclas is going to go for your second question. Firstly, I'm going to disappoint you. No, we will not give you some more guidance on exact how much we anticipate to exit. But I can do confirm that we are actively engaged in all different parts of our portfolios and every – in all of our business areas to work on this.

But it's also kind of a right bucket, left bucket where you define things. In many of these occasions, it's about that we have maybe, let's say, a contract that is sub-performing, and we engage with that customer in trying to find a way forward to fix that. It could be through a different type of offering or a price change or something like that that will turn that contract into profitability. Then, that will end up in kind of the price/mix bucket.

If we can't see a way towards a sustainable, profitable operation, we will exit and then it will end up as an exit. But I will not disclose what our ambition will be in that regard for 2023. But to your question, if it's included in our growth forecast, the answer is yes.

Sebastian Kuenne
Analyst, RBC Europe Ltd.
Q

Okay. Thank you.

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB
A

Yeah. Yeah. Yeah. So of course, we take portfolio management into account when we look into the future, and then provide the guidance, as Rickard says. In terms of iron ore and market prices, I'm sure you are much better to predict that. But just a reminder, we buy very little, actually, raw materials when it comes to steel. It's mostly components, which then kind of adds to the kind of gap between what's happening to the spot prices to iron ore and what's the effect then on the P&L on the cost. So that's a reason also for why there's quite a gap between kind of market prices and what we see in our P&L.

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB

A

Thank you, Niclas.

Sebastian Kuenne
Analyst, RBC Europe Ltd.

Q

Yes, exactly. And that's why...

Rickard Gustafson
President, Chief Executive Officer & Director, SKF AB

A

Sorry.

Sebastian Kuenne
Analyst, RBC Europe Ltd.

Q

And that's the question I have. So how do the customers pass those energy costs on? And when we look at the market prices, London Metal Exchange and so on, these are not the price that you would have to pay. You pay contract prices. And so my question is, have the energy cost – the rising energy costs been fully passed on and can we see an improvement going forward or are we still on an upward trajectory for the contractors who have supply contracts?

Niclas Rosenlew
Chief Financial Officer & Senior Vice President-Group Finance, SKF AB

A

It's an ongoing thing. I mean we have large teams involved in sourcing, of course, and ongoing price discussions with our suppliers as we do have them with our customers. So it's a bit tricky to provide a general answer to the specific question, has everything been passed on or not? So, ongoing work.

Patrik Stenberg
Director-SKF Group Investor Relations and Mergers & Acquisitions, SKF AB

A

Thank you, Niclas...

Sebastian Kuenne
Analyst, RBC Europe Ltd.

Q

Okay. Thank you very much.

Patrik Stenberg
Director-SKF Group Investor Relations and Mergers & Acquisitions, SKF AB

A

...and sorry for cutting the question a bit short, Seb. We have completed our full hour that was allocated for this exercise. So with that, I would like to thank all of you for putting the questions. And we do realize that we have a couple of questions left to answer on the chat. We would be happy to do so afterwards, me and Andreas.

And with that, I'll leave the word for a couple of short closing remarks to Rickard. Thank you.

Rickard Gustafson

President, Chief Executive Officer & Director, SKF AB

Yeah, very short then. Thanks. Thank you very much. Again, just to reiterate the main message from today. We are pleased to see a sequential improvement in our financial performance in – from in Q4 versus Q3. And as was described, we believe that we have made a lot of a heavy lifting in 2022 that built a strong foundation for 2023. So I think I end there, and I thank you so much for your attention this morning, and I wish you a very good day. Thank you.