Company Name: Whirlpool
Company Ticker: WHR US
Date: 2018-07-24
Event Description: Q2 2018 Earnings Call

Market Cap: 8,436.35
Current PX: 129.79
YTD Change($): -38.85
YTD Change(%): -23.037

Bloomberg Estimates - EPS
Current Quarter: 4.385
Current Year: 15.458
Bloomberg Estimates - Sales
Current Quarter: 5428.714
Current Year: 21399.000

Q2 2018 Earnings Call

Company Participants

- Max Tunnicliff
- Marc Robert Bitzer
- James Peters

Other Participants

- Curtis Nagle
- David S. MacGregor
- Sam J. Darkatsh
- Susan Maklari
- Kenneth R. Zener
- Michael Dahl
- Alvaro Lacayo
- Michael Jason Rehaut

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to Whirlpool Corporation's Second Quarter 2018 Earnings Release Call. Today's call is being recorded.

For opening remarks and introductions, I would like to turn the call over to Senior Director of Investor Relations, Max Tunnicliff.

Max Tunnicliff

Welcome to our second quarter 2018 conference call. Joining me today are Marc Bitzer, our Chief Executive Officer and Jim Peters, our Chief Financial Officer. Our remarks today track with the presentation available on the Investors section of our website at whirlpool.com.

Before we begin, let me remind you that as we conduct this call, we will be making forward-looking statements to assist you in understanding Whirlpool Corporation's future expectations. Our actual results could differ materially from these statements due to many factors discussed in our latest 10-K and our other periodic reports.

We want to remind you that today's presentation includes non-GAAP measures. We believe these measures are important indicators of our operations, as they exclude items that may not be indicative of or unrelated to results from our ongoing business operations. We also think the adjusted measures will provide you a better baseline for analyzing trends in our ongoing business operations. Listeners are directed to the supplemental information package posted on the Investor Relations section of our website for the reconciliation of non-GAAP items to the most directly comparable GAAP measures.

At this time, all participants are in listen-only mode. Following our prepared remarks, the call will be opened for analysts' questions. As a reminder, we ask that participants ask no more than two questions.

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With that, let me turn the call over to Marc.

Marc Robert Bitzer

Well, thanks and good morning, everyone. On slide 3, we show our second quarter highlights. As you saw in our press release, we expanded our ongoing EBIT margins in a very challenging cost environment. We delivered second quarter ongoing EBIT margin of 6.7% and a ongoing earnings per share of $3.20.

Since mid-May, a number of elements in the macro environment worsened significantly. In addition to continued raw material inflation, we experienced a temporary, but significant decline in U.S. industry demands, headwinds related to U.S. tariffs as well as the Brazilian trucker strike and currency fluctuations in Russia and Latin America. While these macro challenges impacted our results negatively, the actions we put in place over the past few quarters, including cost-based price increases and targeted cost reduction throughout the world, enabled us to largely offset these challenges and expand ongoing EBIT margins year-over-year. We're very pleased with the strong price/mix driving significant year-over-year and sequential improvement on a global basis and positive in all regions.

In Europe, we were unable to overcome macro headwinds due to slower progress than expected as we work to recover volumes in the region. As a result, we are taking strong actions to restore growth and profitability in the region, which I will discuss in further detail later in the call. We drove strong performance in our North American region delivering almost 12% EBIT margins, despite a 5% decline in second quarter industry demand, continued raw material inflation, and rising freight cost.

As previously announced, during the quarter, we agreed to sell our Embraco compressor business and in anticipation of the proceeds from that sale, we executed a tender offer during the quarter and repurchased approximately $1 billion of common stock. GAAP results were negatively impacted in the second quarter by approximately $860 million due to asset impairment charges primarily related to our Europe results which did not improve as anticipated and a preliminary settlement on a previously disclosed French Competition Authority investigation.

Turning to slide 4, I will discuss our second quarter results and 2018 guidance. Our revenues declined approximately 4% during the quarter. Sales were impacted by weaker-than-expected industry demand in the U.S., slow progress on volume recovery in Europe, and the Brazilian trucker strike. Ongoing EBIT margins were 6.7%, 20 basis points above the prior year, as strong global price/mix more than offset unit volume declines and significant cost inflation.

Year-to-date free cash flow is below the prior year, primarily driven by working capital timing related to lower production volumes. Regarding our full year forecast, we reduced our guidance components due to weaker-than-expected second quarter results and increasing cost headwinds in the second half, which we now expect to be more significantly than previously forecasted.

We will discuss our guidance in more detail later in the call. While our second quarter results were below our original expectations due to additional headwinds towards the end of the quarter, we are at the same time encouraged by the strong price/mix progress and margin expansion year-over-year. This gives us the confidence that the underlying fundamentals of our global business are strong and we, therefore, continue to expect to deliver significant shareholder value in the coming quarters.

On slide 5, we show the drivers of second quarter margin performance. Our global price/mix improved both sequentially as well as year-over-year and was positive in all four regions. I will discuss price/mix further on the next slide. We delivered positive gross cost takeout as our restructuring and fixed cost reduction actions continued to progress. However, these benefits were partially offset by a rising freight cost, primarily in the U.S. and Brazil due to oil price inflation and fleet shortages, as well as the conversion impact of short-term volume weakness in multiple regions. Raw material inflation continued to be a significant year-over-year headwind, impacting second quarter margins by 125 basis points.

Turning to slide 6, we demonstrate our commitment to delivering significant price/mix performance. In total, second quarter price/mix improved by approximately 200 basis points compared to the prior year and we delivered positive

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price/mix in all regions. This represents a sequential improvement of 100 basis points, as we continue to realize the benefits of global cost-based price increases implemented late last year and into the second quarter. Average price per unit improved over 5% on a global basis, including a double-digit improvement in Europe and 8% improvement in North America. Finally, we recently announced additional cost-based price increases in Canada and Latin America which are effective during the third quarter.

Given the weak second quarter performance in Europe, I'd like to discuss the Europe business in more detail on slide 7. Over the past several quarters, challenges related to the Indesit integration, continued execution issues and changes in the macroeconomic environment have led to weak business performance. During the integration, we experienced product availability issues, as we completed factory platform and system integration.

During the first half of 2018, trade customer negotiations, which position us well for future, had a significant impact on volume, especially when combined with our implementation of cost-based price increases. At the same time, our business continues to be impacted by raw material inflation and currency volatility in the region. While these challenges have led to results well below our expectations, we continue to have confidence in our structural position in Europe.

The Indesit integration activities are now complete. Our factories are optimized, platforms and systems are integrated, and our streamlined brand portfolio is well positioned to build upon our leading positions in many European countries. While we are encouraged by our structural position, we have made slower-than-expected progress to regain volumes in the region. As a result, we have identified strong actions necessary to address disappointing execution and drive value creation.

While we are pleased with our progress on improving price and mix, including double-digit average price per unit improvement in the second quarter, we will now balance our efforts around stabilizing and recovering volume with targeted actions on a country-by-country basis. We're also redefining our overall business strategy in the region to drive value creation, including a stronger focus on the profitable kitchen business, the implementation of additional opportunities for cost reduction, and a focused portfolio optimization.

Finally, we're implementing broad leadership changes in the Europe region, including changing the region president. While our short-term focus in the second half is on restoring a breakeven business, we now expect to deliver roughly 4% to 5% margins by 2020 and in the long term, we continue to expect 8% margin in Europe.

With that, I'd like to turn it over to Jim to review our regional results.

James Peters

Thanks, Marc, and good morning, everyone. Turning to slide 9, we review the second quarter results for our North America region. We delivered strong margins demonstrating the fundamental strength of our North America business, while overcoming significant external headwinds. Net sales of $2.8 billion were impacted by soft unit volumes, primarily driven by weaker-than-expected industry demand in the U.S. We believe this current quarter weaknesses largely represents a volume shift between the first and second quarters related to competitor stockpiling of inventory to avoid the safeguard remedy on washers and cost-based price increases in laundry.

As we move into the second half, we believe that industry shipments will return to more normalized levels as the underlying drivers of the U.S. industry remain favorable. Overall, we delivered strong 11.9% margins through significant price/mix improvement, which offset significant industry demand weakness, unfavorable conversion due to volume reductions, and a $40 million impact from cost inflation. We expect to continue benefiting from our previously announced price/mix actions in the second half as well as innovative new product launches and strong cost takeout programs.

Turning to slide 10, we review the second quarter results for our Europe, Middle East and Africa region. Net sales were down 9% versus the prior year. Ongoing EBIT margin declined versus the prior year, as positive price/mix was more than offset by unit volume declines, significant raw material inflation, and currency headwinds. In total, the

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combination of raw material inflation and unfavorable currency impacted results by approximately $30 million, or 300 basis points.

While we are pleased with double-digit improvement in our average price per unit and strong price/mix, we are not satisfied with our progress on recovering volume following the trade negotiations and private label volume actions we took during the first quarter. As a result, we are taking strong actions, the strong actions Marc discussed earlier. These actions are the right next steps for our business and will enable us to get back on track to our long-term goals for the region.

Turning to slide 11, we review the second quarter results for our Latin America region. Net sales and EBIT were both down versus the prior year. Our cost-based pricing actions continued to progress as we delivered positive price/mix in the quarter. However, unit volumes declined versus the prior year, primarily due to the Brazilian trucker strike which impacted both our home appliance and compressor businesses in Brazil. In total, the strike unfavorably impacted volumes by approximately 300,000 units and EBIT by approximately $20 million.

Due to the timing and scope of the trucker strike, we were unable to recover the volumes in the quarter, but we do expect some recovery in the second half of the year. In addition to the trucker strike impact, continued weak global compressor demand led to a $10 million EBIT decline. As a result of continued cost pressures in June, we announced new cost-based price increases in Brazil, Mexico, and Argentina, effective July 1. We will continue to focus on balancing price/mix and volume in the region, while aggressively managing cost to improve profitability.

Now, we turn to the second quarter results for our Asia region, which are shown on slide 12. Ongoing net sales increased 6% versus the prior year. We delivered ongoing EBIT of $43 million, a significant improvement versus the prior year. Our second quarter results were positively impacted by double-digit unit volume growth and positive price/mix. We delivered strong results despite raw material inflation and currency impacts totaling approximately $15 million.

We continue to deliver strong results in India with double-digit unit volume growth, share gains and positive price/mix. In China, we delivered positive price/mix and the net impact of discrete items favorably impacted both GAAP and ongoing EBIT by approximately $15 million, primarily driven by government incentives. We continue to focus on improving profitability in China through price/mix and disciplined cost management.

Now, I'd like to turn it back over to Marc to review our guidance.

Marc Robert Bitzer

Thanks, Jim, and turning to slide 14, we review our updated guidance assumptions. As I mentioned earlier, we have revised our 2018 guidance as a result of stronger macro headwinds and a weaker-than-expected performance in the second quarter. We now expect flat revenue for the year, as our strong global price/mix is expected to be offset by volume weakness primarily in Europe.

We are reducing our global growth expectations, but we expect the U.S. industry to recover and contribute to growth in North America in the second half. We now expect to deliver ongoing EBIT margin of approximately 6.9% for the year. I will discuss the updated drivers of our EBIT margin guidance on the next slide. As a result of lower earnings expectations, we have reduced our cash flow guidance to approximately $850 million and overall we now expect to deliver record ongoing earnings of $14.20 to $14.80 per share.

Turning to slide 15, we show the updated drivers of our EBIT margin guidance. We now expect to deliver approximately $400 million or 2 points of net benefit from improved price/mix as our global cost-based price increases have delivered strong results. We reduced our expectations for gross cost takeout as volume weakness in multiple regions have impacted conversion and fuel price inflation in certain countries has impacted our freight costs. However, our fixed cost reduction actions remain on track to deliver $150 million benefit for this year.

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Finally, we now expect raw material inflation to be approximately $350 million in 2018. We continue to see significant inflation across a number of commodities and, in particular, with our biggest purchase items; steel and resins. Global steel costs have risen substantially and in particular in the U.S., they have reached unexplainable levels.

While the U.S. steel has also historically priced at a premium to the rest of the world, most recently the U.S. steel is 50% more expensive than the rest of the world and simply cannot be explained by the input costs. Our annual steel contracts and hedging contracts with our base metals give us some protection, but they do not insulate us from these more material trends. And recently, we also experienced cost inflation increases due to rising oil prices and U.S. supply chain capacity constraints. And as we mentioned in prior earnings calls, we cannot hedge resins and it was exposed to the quarterly price inflation.

Finally, uncertainty related to tariffs and global trade actions have also led to increased costs for certain strategic components and finished goods imports and exports. While these increased raw material headwinds are significant, we've also demonstrated our ability to overcome these types of challenges in the past through a variety of means, including cost-based price increases, cost reductions and efficiency improvements. And we will continue to do so.

Now, Jim will cover our regional guidance and cash priorities.

James Peters

Thanks, Marc. On slide 16 we show our regional industry and EBIT margin guidance. We have slightly reduced our expectations for full year industry growth in the U.S. and Brazil as a result of the weakness in the second quarter. In North America, we are encouraged by the strength of the U.S. economy, including low unemployment and healthy housing demand. We believe the industry is well-positioned for growth in the second half of 2018.

Despite significant raw material inflation, we expect to deliver approximately 12% margin in North America with industry growth now expected to be approximately 1% to 2% given the Q2 softness. In EMEA, we now expect to deliver ongoing EBIT margin of approximately negative 1% as a result of soft volumes and continued external headwinds. In Latin America, we expect to recover a portion of the trucker strike impact in the second half and now expect to deliver EBIT margin of approximately 6%. Finally, we continue to expect to deliver approximately 5% EBIT margin in Asia.

Turning to slide 17, we review our updated free cash flow guidance for 2018. We have reduced our guidance for cash earnings as a result of slower recovery in Europe, increased cost inflation expectations, and unfavorable currency fluctuation. The asset impairment Marc discussed earlier does not have an impact on cash and the preliminary French Competition Authority settlement is expected to impact cash in 2019. In total, we now expect to deliver free cash flow of approximately $850 million.

Turning to slide 18, we show our capital allocation priorities for 2018 which are unchanged. During the quarter, we announced the sale of our Embraco business and continue to expect to close the deal in early 2019. In anticipation of the closing of the sale of our compressor business and the receipt of the sale proceeds, we entered into a term loan facility and repurchased $1 billion of common stock in the second quarter. And we expect to continue repurchasing shares in the second half.

Now, we will end our formal remarks and open it up for questions.

Q&A

Operator

[Operator Instructions] We'll take a question from Curtis Nagle of Bank of America Merrill Lynch.

<Q - Curtis Nagle>: Thanks very much for taking the question. So, I guess my first is just, could you talk a little bit more about the balancing between volumes and pricing? And I guess specifically, what are the strong actions you guys plan to take to narrow that gap? And how you think you'll achieve that given that it appears that competitors aren't being quite as aggressive on pricing?

<A - Marc Robert Bitzer>: Curtis, it's Marc. So, I presume you asked the question on global and not particularly on a specific region level and, of course, the situation also in competitive environment and most of the timing of our price increases is different region by region. So, let me maybe try to address it for both North America and Europe and then we can also go, if you wish so, more into Latin America or Asia. So, in North America, as you know, we went out with a kitchen price increase which was effective in the first quarter and a laundry price increase in the second quarter.

As you can tell from our remarks and from the numbers, we had a very strong pricing progress year-over-year and sequentially, and we also going into the promotion period around July 4, we decided to stand firm on our pricing increases and we executed accordingly. Obviously, I cannot comment on what competitors are doing or not doing. That's their decision. We've seen over the July 4 period that not everybody was sticking to similar price increases, but again that's normal promotion environment and I'm not reading too much into this one. Again, I can only reaffirm we are standing firm on our price increases and because we're committed that's the only right thing to doing with such a cost inflation environment.

On Europe, I would say we kind of – and this is country by country very different. We started going up with some price increases in October and executed a lot of them until February, but again on a country-by-country base. I would say here and, again, the competitive environment is highly fragmented and it's country by country very different, so there's no generic comment. I think we saw a volume impact, but that wouldn't only tie it back to the price increase because at the same time we were trying to address terms and certain unfavorable trade contracts, which we have with certain trade partners. I wouldn't put it all on pricing, but again also here and this is what we communicated before, now our job is to hold firm on these price increases and rebound some of the volume and some of the volume losses in the second half.

<Q - Curtis Nagle>: Okay. Maybe that segues into, I guess, my next question on EMEA. So, just from an EBIT perspective, another disappointing quarter. It sounds like a lot of the same issues that dragged earnings in 2Q were still there, so I guess what is or isn't happening? Why has it been so difficult to regain those slots, as you'd mentioned? And can you be a little bit more specific about some of the actions you plan to take aside from what sounds like some leadership changes and change in strategic direction?

<A - Marc Robert Bitzer>: So, Curtis, obviously in Europe and we said that before, we're disappointed that Q2 was not yet any better. First of all, to put in global context, the same inflationary challenges which we have throughout the rest of the world also impacted our European numbers, as you've seen in some of the numbers. So, that's an additional burden which we had in this one.

On the volume side, it frankly took us a very long time to resolve some of these trade contracts which are now by and large resolved. But as you also know in a competitive environment, it's not that easy just to regain the floor spots which we lost over last six months quickly overnight. We're making progress and right now even in a disappointing Q2, it got better month over month over month. But again, that's the number one priority for the second half that we regain the floor spots, rebalance without giving up our price increases, and in the same time refocus our strategy, particular on the, what is in Europe very profitable, the kitchen business.

Operator

Our next question is from David MacGregor of Longbow Research.

<Q - David S. MacGregor>: Yes. Good morning.

<A - Marc Robert Bitzer>: Morning, David.

<A - James Peters>: Morning, David.

<Q - David S. MacGregor>: Just to start off with a question on raw materials. I guess, the guidance has been $250 million to $300 million. It was supposed to reflect not where raw material inflation was at the time that you'd posted that guidance, but rather where you thought it might eventually get to. So, presumably some cushion in there. Now, the increase to $350 million, can you just talk about where in the world, which geographic segments or which materials did you see the incremental inflation that's responsible for the upwards adjustment? And how much cushion do you have now?

<A - James Peters>: Yeah, David, so this is Jim. And I think if we go back to our previous guidance, what we've seen since then is we've seen continued pressure on steel costs, primarily in the U.S., but also some globally. Resin cost, especially as oil has risen in the last – in recent times, we've seen an increase in oil prices that have pushed that up on a global basis, but some of it concentrated more within the U.S. market right now. Additionally, even as we look across many of the base metals, those have all gone up from our assumptions earlier in the year. So, it's been rather broad based with a significant concentration in steel and a disproportionate amount hitting us in the U.S. at this point in time.

<A - Marc Robert Bitzer>: So, maybe, David, also to add on this one, first of all, you are correct, when we give a raw material guidance, it's a forward-looking assumption. So, this is not reflecting spot markets of past, which also tells you our forward-looking assumptions for the year have changed. And it's coming back to what Jim said before. If I basically put it in, call it, four different buckets, they almost follow the size of our respective raw material purchase.

The biggest concern structurally is steel, steel increased across the world, but particularly U.S. have increased. Now, we have some protection due to our annual contracts, but as I said before, we're not completely insulated. Two is the resins which have risen substantially and as you know and we indicated that before, we cannot hedge for resins. So, we basically are exposed to quarterly inflation and the resins have not come down. And then, three and four, almost the same order, it's kind of the freight, not just impacted by fuel, but also by freight shortage, that has risen substantially in kind of the second quarter.

Now, technically, that's not sitting in our raw material, but sits in our ongoing cost productivity, but it's also an element. And lastly, and again that has only a limited impact Q2, but on a forward base has some impact, as we are impacted by the tariffs [ph] either than we are (25:09) – import of records of our suppliers who have to basically pay the tariffs. So, that is an impact going forward, but to a lesser extent in the second quarter.

<Q - David S. MacGregor>: There has been – one of your competitors has gone for a small price increase effective in August. Can you just talk about the extent to which you feel and maybe you have already raised prices again here this summer for the second half benefit?

<A - Marc Robert Bitzer>: And, David, as you know, that's consistent with all our prior earnings calls, obviously, I cannot and will not comment on future price increases. So, you need to judge us from the past. I would say throughout the world, but also in particular in U.S., when we saw the first signs of cost inflation throughout the business, we decided to go forward with price increases. That's what we've done in the U.S. and throughout the world. And, of course, we're monitoring the situation very closely and as I said in my prepared remarks, whenever you face with a significant raw material inflation, you look always at a multiple set of options, cost-based price increases, cost reduction programs, supplier negotiations as one of them and we intend to do so.

<Q - David S. MacGregor>: Yeah. Second question, if I could, was just on Europe. You talked about sort of a consolidation of a lot of different markets. It strikes me that maybe UK was a disproportionately negative contributor to the results there and the problems that you're facing. Can you just sort of deconstruct the European aggregate for a moment and just talk about which countries are a particular problem and how you plan to remedy that?

<A - Marc Robert Bitzer>: Yeah, I mean, David, again, without breaking down [ph] in velocities here (26:38), but more in a, call it, two years' perspective as opposed to just the quarter, historically, our European business, particularly the Indesit side of our business used to make a lot of profits in Russia and UK. Both markets have, as you know, significant currency and also demand volatility to a downward and that is still structurally burdened because, obviously, all products being imported in the UK, you just don't realize the same margins. On top of that, demand is very slow in

UK.

To some extent, the same is true for Russia where we had a significant currency exposure over two years. I would say UK in the second quarter was not necessarily the decisive factor. Russia impacted us, because the currency got a lot weaker, but we also had some challenges in other markets. I would say the encouraging thing is, I think our historical core markets like France, to some extent like Italy and Germany have started to stabilize and we see some positive signs there.

Operator

We'll take our next question from Sam Darkatsh of Raymond James.

<Q - Sam J. Darkatsh>: Good morning, Marc, Jim. How are you?

<A - Marc Robert Bitzer>: Good, Sam.

<A - James Peters>: Good, Sam. Morning.

<Q - Sam J. Darkatsh>: A few questions I wanted to make sure I'm clear with. So, what you're saying, Marc, is that subsequent pricing from here is not in the guidance. And so, if you were to take pricing from here, it would be incremental to guidance. Is that how to understand your commentary?

<A - Marc Robert Bitzer>: Well, again, Sam, obviously, we cannot communicate for a number of reasons on future price increases. [ph] Apart from that, there's always (28:20) also competitive reality, which I don't want to put all our cards on the table. Having said that, our margins – our guidance assumptions right now include the current raw material assumption of $350 million and, of course, include the continued discipline on the cost-based price increases and as you've seen, we upped what we assume on a full year price benefit from 1.25% to 2.0%. So, we have included in the guidance, also technically we included already the Canada and the Latin America price increase because we have announced them, but not anything beyond.

<Q - Sam J. Darkatsh>: Okay. And then, my real question would be twofold. First off, when do you expect laundry margins, specifically washing machine margins to approach or approximate fleet average for North America? And then secondly, for raw materials, I know you said that you're insulated this year based on contracts and hedging and forward purchasing, but if you were to mark to market what you're seeing right now, what would 2019 inflation look like at present?

<A - Marc Robert Bitzer>: Sam, these are two questions. So, let me first talk about the raw materials. Obviously, we're not giving 2019 guidance on raw materials at this point. And also to be – because I think it's important to be clear on my earlier remarks. On steel, we have annual contracts. They protect us to some extent, but given that there is some element of indexing, they don't completely insulate us, so there is still some steel element. Second of all, not all parts of awards you have annual steel contracts, so in some of them you buy short. Thirdly, there are certain steel parts, not necessarily the cold rolled steel, but specialty steels like black stainless steel where we don't have annual contracts. So, we are impacted by steel prices on our current base.

The other big ticket item are resins. We are not on annual contracts in resins because you simply can't get annual resins contract. So, we are fully exposed to the quarterly inflation what we see in these markets. And on all the other base metals, which as Jim mentioned earlier, where we have also some inflation, we have hedges in place, but of course you roll – at one point you run out of hedges and you're not 100% hedged at any given time. So, there are certain exposures, and we've got to see also how the future price trends evolve. Having said that, we're also convinced that certain spot prices which we see right now, in particular on steel, we do not believe they're sustainable in the external market, because they're simply disconnected from the input costs and they're also disconnected from rest of the world.

Now, coming back to washer margins and again, as you know, we don't reveal margins by region or by product platform. Having said that, the washer business as such in Q2 was impacted by a very slow market demand in Q2, which you probably can relate back to strong demand in Q1, so probably our first half it was more balanced, but the Q2

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demand on washers was very soft and we have a benefit from a cost-based price increases. So, I would say our EBIT margins on laundry have improved, but they have not yet reached fleet average.

Operator

Our next question is from Susan Maklari of Credit Suisse.

<Q - Susan Maklari>: Good morning.

<A - James Peters>: Good morning.

<A - Marc Robert Bitzer>: Good morning, Susan.

<Q - Susan Maklari>: I guess, first, I wanted to get a little bit more color on North America. You said that you expect things to recover. So, coming out of the quarter, have you started to see volumes improve for either your business or for the industry broadly? And how do you think about that coming together in the back half of the year?

<A - James Peters>: Yeah, Susan. This is Jim. I think as we mentioned before, the first way we look at it is that Q1 was significantly strong and some of that, we believe, was due to some load-in especially of laundry products during that quarter which balanced itself back out in the second quarter. As we look at the third quarter, we're very early in the quarter at this point in time.

And so, as we look at what we believe the underlying drivers of demand are and sell-through and other things, what we really reflect and said is we've taken our industry guidance from 2% to 3% down to 1% to 2%. As we do believe a little of that softness within Q2 will not be made up in the back of the year, but we expect at least U.S. demand to normalize back closer to the levels where we had expected for the full year just realizing that the first half of the year was flat and we probably won't make that up.

<A - Marc Robert Bitzer>: And, Susan, it's Marc. So, let me maybe also add some additional color. So, as Jim indicated, Q1 industry was very solid, Q2 it was down minus 5%. So, on the first half, it was approximately flat. Frankly, we did expect some rebalancing of the inventory which was also related to the price increase and the pre-buy. We expected some rebalancing in April, May.

I think if you want to [ph] say it's a surprising element (33:18), but June demand was soft, which is an indication of July 4 as an overall period was softer than usual years. So, I think that's impacting the first half. Having said that and, of course, we look at housing data and everything else, we still believe the fundamentals of a healthy U.S. market are in place, but of course we're observing all parameters. But with that first half softness if you want to say, so in particular the June one, we took out full year guidance despite the confidence of a structural health of the market down to 1% to 2%.

<Q - Susan Maklari>: Okay. And then, I guess, in thinking about the pricing, have you seen a mix shift as a result of that? Do you see consumers sort of moving down in terms of price? And is that changing any of the broader market share positions out there?

<A - Marc Robert Bitzer>: Susan, again, it's Marc, and it's of course different region by region. But if I stay focused on North America, typically when you go up with these cost-based price increases, you sometimes have a mix element, [ph] i.e., the risk of which you (34:18) sometimes have, that you mix down. Having said that on this one because it's so heavily cost based, we have driven price increase for our entire product range. So, we didn't see a massive mix shift, if you want to say so. What it did impact, we lost some volumes on the low end, in particular around the promotional periods because [indiscernible] (34:40) advertiser promotion, active product in the SKU. So, it's not necessarily, but from an ongoing basis we lost mix but, yes, throughout the promotional period, on the low end we lost some volume.

Operator

Our next question is from Ken Zener of KeyBanc Capital.

<Q - Kenneth R. Zener>: Good morning, gentlemen.

<A - Marc Robert Bitzer>: Good morning, Ken.

<A - James Peters>: Good morning.

<Q - Kenneth R. Zener>: I wonder if I could just take a step back. I really want to try to put this quarter and your outlook in the right context. So, if I think back to 2011 going into 2012 when you pursued pricing then, your margins – focusing on North America, your margins were 3% going to ultimately 8% in 2012, which was good. And now you're looking to get price to attain your 12% margin target. So, in 2012, [ph] AM (35:31) fell about 2% that year. Can you talk to the implied elasticity in appliance demand, because obviously you're talking about a "normalizing second half," and I'm just trying to discern the, perhaps, elasticity on pricing? You talked about July 4 promotional weakness, as opposed to a cyclical softening. I just want to kind of clarify your macro thoughts there, first of all. Thank you.

<A - James Peters>: And, Ken, before Marc kind of goes into some of the elasticity, let me just take you to that 2011 and 2012 that you talked about. The margin expansion there, yes, there was significant pricing and there were multiple cost-based price increases during that time, but also there was a significant amount of fixed cost takeout. So, you can't compare the pricing results necessarily of 3% to 8% to what we have now. But you are correct on the margin expansion there, but there were multiple drivers.

<Q - Kenneth R. Zener>: Okay.

<A - Marc Robert Bitzer>: So, Ken, let me maybe also add a couple of comments. First of all, before we can get to price elasticity, also if you take it in broad historical context. Of course, these Q2 numbers were not in line with our expectation or your expectation. At the end of the day, we also got to recognize that despite an extremely challenging cost environment, we have expanded our ongoing margin.

And I'm really encouraged by the actions that we've taken in October and the first quarter around the fixed cost reduction price increase, because it just showed even in extreme environment, we can [ph] weather (37:02) and we can expand the margin, and these actions will also give us quite a bit of momentum in the back half. So, as much as we are kind of disappointed about the short term, we're encouraged by how the total business was able to expand the margin in this environment.

Now, specifically on the price elasticity, and again this is – a lot has been written, and there's a lot of moving parts, obviously, and this is very different by category by category. The fundamental thing which we need to keep separate is what is kind of, call it, category price elasticity, i.e. industry as such versus cross price elasticity, i.e. versus our competitors at a given price point. Of course, you have a substantial cross price elasticity, particularly when you come to laundry low-end price points, not necessarily by high-end price points. And that's just a given. That's a reality of a competitive environment.

But category price elasticity, we repeatedly said that in the past, I don't think is very high, i.e., of course, in the short term, you may see some moving pieces. But in a developed mature market like the U.S., where so much is – particularly on the laundry side, it's not necessarily all housing related, it's replacement related, innovation related, you typically don't see on a full year base a massive of a big price elasticity on the entire category. Kind of month to month you might see it, but not on a full year base.

<A - James Peters>: Yeah. I think, Ken, the one other thing to point out, too, and if you look back historically, the price increases that you had referred to earlier, we had taken more at the tail end of the commodity inflation period. Right now, as Marc pointed out, we've taken cost-based pricing in the middle of the commodity inflation period that's continued, and it's allowed us to expand our margins this quarter year-over-year despite the fact that we're dealing with significant raw material headwinds. And I think that's a positive to point out here, that we've really – we've taken these cost-based price increases much earlier in the process.

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<Q - Kenneth R. Zener>: Thank you. My second question is regarding Europe, considering the 4% margin in 2020. If we think back to the Indesit acquisition, how much is kind of – could you isolate some of that shortfall just to the UK and competitive situations there? Or is there something – I heard you say the 8% long-term margin as well, but it seems like it's getting farther away. So, is there something structural that changed within the different countries you're – obviously, you lost floor space, so your relationship to the retailers was weakened within country which I think is very important, but could you talk about why that 8% seems so far away now, if it was a structural change, or if it was the UK, or really the IT transition that led to the market share that's not as quickly recoverable? Thank you.

<A - Marc Robert Bitzer>: And, Ken, let me try to address it even though obviously that it's probably – at one point [ph] as far as an (39:55) analyst conference, we got to give you the full story, but the short one is; first of all, when we talk about the 4%, let's also not lose sight of – we had in business already a 4% post the Indesit acquisition. Actually, in 2014-2015 we had a 4%, 4.5%, so it's not kind of – it's not a new number, we had it. You also look at our competitive set, you would easily conclude 6% to 7% margins in this environment are achievable.

Now, to your question about the sources of the losses, I'm not trying to blame it all on UK and Russia. I would say that is approximately half of the losses which we have, and that's just a currency which we don't think will recover in the short term. The other half is also what I would call broader internal execution issues which are related to supply chain and some other elements. So, now to your question, why does it take us longer to get to the 8%, A; yeah, because we don't expect the UK and Russia to recover in a one- or two-year period. I think ultimately it will come back, but it will take a little bit longer.

The other element, and this is just a reflection of a long integration with some, call it, internal focus as opposed to external focus, we lost a little bit of sight of our profitable kitchen business. That is structurally the most profitable business in Europe, but that takes longer to regain because these are typically annual contracts and it's more than just a – it's more than just a floor spot, these are annual contracts which you have to regain and that will take us a little bit longer. But that's the key element to get this business to 8%.

Operator

Our next question is from Mike Dahl of RBC Capital Markets.

<Q - Michael Dahl>: Good morning. Thanks for taking my questions.

<A - Marc Robert Bitzer>: Good morning.

<Q - Michael Dahl>: Marc, the first question I want to follow up on the EMEA discussion, and you talked about some of the rebalancing around the kitchen, but it sounded like there's kind of some retrenchment and reallocation of resources there as well. Could you give us a little more detail around whether there is an underlying cost plan and whether we should expect some pullback in some of the non-kitchen-related businesses as you kind of shift your focus back here?

<A - Marc Robert Bitzer>: Michael, let me just try to address it. I mean, so first of all, there's a short-term rebalancing of the volume which is more related to specific trade actions and floor spaces where we can get it, which is typically more of a freestanding. The kitchen takes, as I mentioned before, a little bit longer. I think what you refer to is, in my prepared remarks in terms of – called focused portfolio optimization and basically it comes back to – the European business is very different market by market, asset by asset. And, of course, we are looking at certain very specific assets in terms of do they generate the kind of value which we expect. It's an alternative way to get some value out of this one also to do alternative paths for some of these assets. That is not across Europe, but very specific over countries or product categories.

But you just structurally need to step back and say, does it make sense from a shareholder perspective? And that's part of the effort which we're looking at, coupled with further cost reductions. Europe has had actually – and unfortunately [ph] that's a little bit lost on (43:15) results, but the cost takeout was on track, in line – what we had in line for the integration acquisition. But, obviously, given the volume trends over the last 18 months, you have to dig deeper and

that's the effort which we're undertaking right now.

<Q - Michael Dahl>: Got it. Okay. And on a broader note around the cost takeouts, I think you guys, you have mentioned that there are some offsets around your ability to obtain the gross cost takeout targets originally envisioned just given the lower volumes. But I think if I look across our coverage and what companies are typically doing in the face of these rising raw materials, rising freight costs, it is digging deeper across the portfolio to, if anything, lean into cost actions and whereas now we're seeing the cost takeout figure come down against a rising inflation environment. Can you just help us bridge that a little bit more and are there other – outside of what we just talked about in EMEA, what are some other actions you can take to recapture some of this?

<A - James Peters>: Yeah, so, Michael, this is Jim. And let me kind of start and then Marc can fill in here. To begin with it, late last year we announced a $150 million fixed cost takeout program for this year which we are on track to achieve and halfway through the year we've got about half of the benefits we expect to see in there. The second thing is on our ongoing cost productivity and we've kind of talked about this earlier, while we are seeing progress we're seeing some of that offset with the increased freight and warehousing and oil costs that we see and we don't put that in our raw material bucket. So, right now that is an offset.

The third thing is especially within the second quarter here and I talked about this some with the free cash flow outlook is, we are bringing our inventories in line and reducing some of our working capital levels, but that's primarily by bringing our inventory levels in line with where sales have been in demand. It's been in the first half of the year. And that's caused us to incur a conversion to take a hit within our conversion costs within our factories. Additionally, as we look at within the first half of the year with the Brazilian truck strike, most of the cost of that, as we were unable to produce and deliver goods, is sitting within that. So, we do expect the second half of the year to see a more positive type of picture from a ongoing cost productivity.

<A - Marc Robert Bitzer>: Yeah, Michael, I can only echo what Jim was saying. First of all, what is really important for you from an analyst perspective to look at is, when companies talk about inflation, you've got to keep in mind inflation hits us across a number of parts of our business. What we put in raw material is literally only steel, direct resins and some base metals by and large. All our inflationary elements sits technically [ph] and we showed on is (46:06) ongoing cost productivity. So, if we have higher freight costs because of shortages or if we have labor inflation, all these aspects, they reduce the ongoing cost productivity, of course, that impact us.

The second part is, and what Jim was alluding to, is really important. We exited the year with elevated inventory levels and we decided to take down inventory levels in a very aggressive manner and as you've seen, our inventories are flat to even down versus last year at the end of Q2. What it also basically means beyond the volume decline in Q2, we took additional actions to reduce our production and, of course, as such had a deleveraging in our conversion cost, and that was material and significant and that was reducing the ongoing cost productivity. On a go-forward base and let's get back to your question, of course, we're doubling down on our cost initiatives and we're shifting some resources into what further cost reductions we can do either on variable costs or on fixed costs.

Operator

We'll take our next question from Alvaro Lacayo of Gabelli & Company.

<Q - Alvaro Lacayo>: Good morning. I just wanted to touch on Latin America. The full year guidance seems to incorporate a rebound in the second half. Maybe if you could just go over the dynamics that impacted the second quarter and maybe make some comment around what gives you the confidence that you'll be able to improve from Q2 given that consumer confidence seems to be declining over the last few months in Brazil particularly.

<A - Marc Robert Bitzer>: Alvaro, it's Marc. So, first of all, structurally, I mean the Q2 results were impacted by Brazil. What we call [ph] LAR now (47:47), i.e., from Mexico down was actually in a very healthy state and we had a good business there, and we also expect that going forward. And we do consider and we said that in the remarks before with despite all the ins and out, the Brazil truck strike was a temporary one. Now, to be more specific, in May it cost us

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almost 30% of the sales in Brazil and so that was substantial, and the industry and us, I'm talking about the broad industry, not just appliance, was slow to recover from that one because it took quite a while to get the trucker availability back, et cetera, et cetera.

So, that loss in Q2 is just there, but at the same time we consider it temporary because now even what we see from the June and July trends, it's back to normal trends. Having said all of that, probably until the elections in Brazil are over, I think you should not expect a big boost from consumer confidence. I think, so we still expect the Brazil industry to be about flat on a full year base. So, no major momentum probably until the elections. But again I want to echo, we do consider the Q2 impacts temporary, and then you've got to keep in mind Brazil had a solid Q1. If you take out the trucker strike, it would have been a solid Q2, and that's what we expect on a full year base.

<Q - Alvaro Lacayo>: Got it. Thank you. And then, with regards to EMEA and all the additional actions that are being taken, maybe if you can discuss when you'll begin to see, in a meaningful manner, sort of the benefits from the additional actions being taken and how you see that. You reset 4% to 5% by 2020, but maybe if you can give a little bit more color in terms of timing of how you see these benefits flowing through the business and when you'll begin to show improvements as time goes on.

<A - Marc Robert Bitzer>: So, Alvaro, first of all, I want to come back to 2018. In our guidance, we adjusted the European margin guidance to minus 1%, that's what we have right now baked in the numbers, and that's what you see there. You put that on top of a first half, it basically tells you the second half we expect to be above breakeven. And that is based on our current actions and the short-term levers which we can pull in the second half. So, again the second half, we expect to be above breakeven. And we also guided towards with 2020 4% to 5%, and I would expect 2019, even though it's too early to give specific regional numbers, to be somewhat midpoint in between.

Operator

Our next question is from Michael Rehaut of JPMorgan.

<Q - Michael Jason Rehaut>: Thanks. Good morning, everyone.

<A - Marc Robert Bitzer>: Good morning.

<Q - Michael Jason Rehaut>: First question, I just wanted to kind of better understand a couple of the comments around Europe. And, Marc, you just mentioned that you're expecting maybe closer to breakeven in the back half as opposed to down 2% to 3% in the first half. At the same time, you commented that it'll be hard to regain some of the floor space in the meantime, I guess particularly around the kitchen business. And you have leadership changes going on. So, I was just trying to understand what are the specific actions that give you confidence in getting to breakeven in the back half. You had mentioned a little bit of cost, maybe a little bit of other businesses getting some floor space back.

And also, how does this interact with the leadership changes? Because it seems like you're kind of already putting into motions different elements of the strategy. Do you have new leadership in place already? Or is it internal movement and you're already kind of pushing some strategy forward and you're just kind of putting in the personnel to implement that?

<A - Marc Robert Bitzer>: So, Michael, let me just address it. So, like in any business, there are certain things you can do in the short term, and there's certain things which take a little bit longer. So, in the short term, again, we're guiding to breakeven and above and that's implied an entire full year margin for Europe. There are certain floor spaces and trade business which you can regain in the short term, particularly around the freestanding business, and there's all certain markets where just certain things are moving faster than other markets. What takes longer is to regain the structural profitable kitchen business. Because again, as I said before, that is typically tied to either annual contracts or what is also very typical in the kitchen that the floor spaces are negotiated on an annual base, it's not something to regain shorter.

So, again, the freestanding business, and I would say in particular in some of the Eastern European markets, but also to some extent Italy, we can regain floor spaces a little bit faster. Other parts take a little bit longer. So, the reset on strategy, that is not something which we're counting on completing in the back half of 2018, but there's operational measures which we can take in the back half of 2018.

What is encouraging is that at least our volume loss got a little bit less every month in the quarter, and that's what we pretty much see also now for Q3. So, things are slowly getting in place. The other element is we have taken additional cost action towards the end of the quarter in Europe and got some benefit out of this one, and that will carry also into Q3 and Q4. So, we have added some further cost action for the back half which will help us to regain that breakeven.

<Q - Michael Jason Rehaut>: And just in terms of the leadership changes, could you give us any color there? How much is in place? How much will be in place over the next few months? And then, I had a follow-up on the second question just on inventory levels, you had mentioned kind of a reduction and trying to get that in line. Does that further impact margins in 3Q versus 2Q as you have some inventory rationalization and that kind of reduces factory optimization? Or can we expect across the board kind of more of a stable narrative there?

<A - James Peters>: I think, Michael, this is Jim. I'll take the inventory one first here and just say that, as we mentioned, we believe we took most of the actions within Q2 to bring our inventories in line with this. At the end of Q1, they were higher than the prior year. Once we got to the end of Q2, they were even to the prior year or better, so we've worked that higher inventory level out. And then, throughout the back half of the year, we expect to continue to reduce inventories, but it will be on what we expect to be a slightly higher level of demand than we saw in certain markets within the first half of the year. So, we don't expect significant impacts within the back half of the year due to reducing inventories.

<A - Marc Robert Bitzer>: So, Michael, the short answer to your leadership changes, we announced that internally last week we have a change of a presidency in Europe, and until we name a successor I will at interim run it. I've run Europe before, so I know the market very well. But, of course, that's not a permanent and long-term solution. But expect us to announce a formal successor in the next one or two quarters.

Operator

And this does conclude our question-and-answer session. I'd be happy to return the call to our hosts for any closing comments.

Marc Robert Bitzer

Yeah. So, as we wrap up here the call, let me also try to summarize some of the key messages on this call, which is also on page 20. First of all, we delivered strong global margin – not strong, but we delivered solid global margin expansion despite the significant macro challenges. We will continue to take actions to mitigate those headwinds and are pleased with strong sequential improvement to global price and mix.

We have also delivered strong margins in North America despite cost inflation in what we believe is a temporary soft U.S. industry. And this performance highlights the fundamental strength of our business. And we are taking finally strong actions to restore profitability in Europe region. And we remain confident that our global business is well-positioned to deliver improved ongoing margin expansion and an all-time record ongoing EPS in 2018. So, thank you for joining us today, and we look forward to speaking with you again on our third quarter earnings call on October 25.

Operator

Thank you. This does conclude our conference call. You may now disconnect your lines and, everyone, have a great day.

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