General Electric Company

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Josh Pokrzywinski: Good morning, everyone. Welcome back to Day 3 of Laguna. Thanks for bearing with us. I know it's a bit of a slog. But as they say, if you're going to hoot with the owls, you've got to soar with the eagles. Thanks for joining us this morning.

We're going to kick off with the team from General Electric. I'm joined on stage by CFO, Rahul Ghai. Rahul, thanks for joining us. Always a pleasure.

Rahul Ghai: Appreciate you guys having us here.

Josh Pokrzywinski: Absolutely. No, wouldn't miss it. Maybe you could just start us off with a bit of an overview, what you're seeing, any other kind of prepared remarks you want to make, and then we'll dive into some Q&A, if that works.

Rahul Ghai: Yeah, absolutely. So, listen, we're excited. Excited as we get ready to launch two new public companies, GE Vernova and GE Aerospace, along with just driving performance both for 2023 and the medium term.

And on separation, momentum is building. Steve and I were just together at our Greenville facility in South Carolina with 125 of our colleagues, as we prepare for departure. And people are jazzed. People are jazzed about the culture we are building, about what lean can do for them, and how it can drive operating performance, and what a standalone public company means for GE Aerospace. On all three fronts, people are really excited.

And as we think about Vernova, clearly the senior leadership team is coming together. We just made two big appointments, Ken Parks as the CFO, three-time sitting public company CFO. I've known Ken for 20-plus years from our days at UTC together. He's going to be a great partner for Scott, fantastic add to the team.

And Vic who has been running Onshore Wind for us and has driven a remarkable turnaround in that business. And when you think about what the business looked like last year with a billion and a half approximately of losses, to breakeven this year in the second half, and improvement in 2024. I mean that's a huge turnaround. And now he's going to run all of Wind, so two key senior positions getting filled there. And then in terms of just the mechanics that are needed to separate two companies, legal entity separation, Form 10, all that, everything is on track.

Then with the work that Larry, Carolina and the rest of the team has done in terms of the significant deleveraging that we have seen with the repayment of debt, and now we're just adding to that by this month retiring the rest of the preferred equity, we continue to liquidate our equity stakes, including actions earlier this week. So just this gives us significant capacity to ensure that both Vernova and Aerospace have a strong balance sheet at spin to achieve investment grade ratings. And with Vernova, they're going to spin it with a net cash position when we launch them.

So really excited, proud of the work the team is doing on separation, so really, really good. Two leading industrial franchises in their industries, both with the majority of the revenue coming from services. So, things couldn't be better set up for both businesses.

Now, switching to performance, let's talk about Aerospace first. Continuing to build on the leading positions that we have in commercial and defense propulsion system services, all of that. And as we think about what's happening in 2023, clearly the demand is very, very robust. And we are trying to ensure that we meet the ramp expectations from our customers on the defense side, on the air framers with the airlines, so a lot of work is going in there and things are looking good.

And for commercial, we expect OE, we expect mid-to-high 20s. Services, given the robust market outlook and the disciplined execution, we expect more than 20% growth in services.

On the defense side, we continue to innovate the future of combat. The book-to-bill has been really strong. Book-to-bill in the first half of the year has been more than 1.3. That ensures robust and continued revenue growth in the outer years. And if you look at both the House and the Senate, excited about the funding of the advanced engine development for the F-35, so things are looking good there as well.

Overall, just it's a good place to be for GE Aerospace, and if we switch over to Vernova, as I'm getting to learn the business, I'm just impressed by the secular demand drivers and the execution that Scott and team are driving. What they are doing with lean is just absolutely amazing.

I was at their Greenville facility last week with our board and just getting to learn how they manage outages. I mean what they've done to fix an outage in the field, they've taken 25% of the time out. They've digitized the whole process, so every technician out in the field instead of getting paper on how to fix an outage, goes out with an iPad and knows exactly what to do. We talk about standard work, and then can provide feedback to the people back home on what needs to get better, so talk about continued improvement. It's just a remarkable thing.

They have standardized the tools, created new tools, have dedicated crews. This is absolutely remarkable. So, you think about what that does for the business, double-digit cost reduction, incremental capacity to do all that. And that's what gives us confidence that Power will remain on track.

And if you switch over to the Renewable side, as I said earlier, turnaround in Onshore and Grid, breakeven in the second half of the year, continued improvement in 2024. Offshore, we're just working through the challenging backlog that we have right now. It's going to take some time. But it remains in line with the expectations that we had outlined back in July.

So, you wrap all that up and say, okay, what does that mean? For 2023, we had a fantastic first half EPS that was greater than all of 2022, free cash flow improvement of more than 1.5 billion over last year, so really, really strong first half, gave us the confidence to raise our outlook for the rest of the year on revenue, EPS, free cash flow, so really good on all fronts.

And as we sit here today, the Aerospace services continues to do well. Renewables and Power are on track. So, we think we are tracking to the higher end of our EPS and free cash flow guidance for the third quarter. That's good.

And we are in the middle of our strategy reviews right now. And as you go through these strategy reviews, it clearly highlights both the significant opportunities and strength of these businesses. So, things couldn't be better, really excited about where we are and what lies ahead of us.

Josh Pokrzywinski: Excellent. It sounds like you guys have a lot of momentum, obviously top to bottom in the organization. I think the one piece that folks struggle with in the context of commercial, particularly commercial services, is that demand has been so strong. Clearly there are bottlenecks in the system, some of which you guys have experienced, some of which come from your suppliers or others in the space.

I'd like to spend a few minutes if we can just trying to understand maybe where some of those friction points are and how we should think about that in the context of GE. Maybe just to rewind a little bit to 2Q. Commercial services up 30, internal shop visits up 10. I know there's a lot going on with spare parts and probably some price and other pieces in there. What are the pieces that we really need to be cognizant of and watching, or that you're watching, just to try to understand how those two maybe come into alignment over time, or how that divergence continues?

Rahul Ghai: Yeah, so on services, just to set the stage, we raised our full-year expectations, so now we think we're going to be growth more than 20%. Most of that is going to come from the robust spare parts demand. So, spares, when we started the year, we were thinking high teens to 20%. Now, we think spares growth is more than 20%. And it's coming from a couple of places.

One, the departure growth is now stronger. We've gone into the year thinking, hey, high teens year-over-year growth. Now, we think it's 20%, something like that. The market environment is a little bit better. Plus, what we've really seen is really good execution by the team in terms of pricing discipline, and driving price increases in the market, so that is helping.

The other part is that the demand out of China was really robust. I mean if you go back to 2022, things were completely shut down, so a huge catch-up in the first half of the year as China departures come back. China departures are probably going to be up double over last year, close to, right? So, a huge uptick in China departures, so that's driving demand out of China. And then the customer mix is good as well. So, all that, so the spares outlook looks better today than it did back in April.

On the shop visit side, we started the year thinking, hey, it's going to be somewhere around the 20% mark. Now, the demand outlook continues to be really strong. As I said, departures are looking better, all that. The challenges come down to supply-chain shortages and challenges. The turnaround times are longer than we expected. With that, we think the shop visits this year are more in the mid-teens than closer to 20, so that's what we are thinking on shop visits right now.

What all that is doing is it's just pushing the demand out. I mean the demand is not going anywhere. Just like, we were expecting high single-digit growth between '23 and '25 when we were out in Paris on shop visits. Now, it's just going to be north of that because some of those shop visits that we were going to do this year have been pushed out.

Overall, I think the services looks really good. I mean the fact is that 20% plus growth this year is going to be good. And on the OE side, we raised our outlook as well. And now we're thinking it's mid-20s to high-20s.

Josh Pokrzywinski: Understood. Following up on just a couple of things you mentioned there. I guess first, on spare parts, obviously spare engines is a different discussion there entirely, not a lot of extra lying around to sell even if you wanted to. But on the parts side, are folks building up inventories? I certainly understand there's a lot of different other points of friction there. Is that something where there's going to be a normalization, or is that just really emblematic of how strong demand is?

Rahul Ghai: No. It is emblematic of how strong demand is and how we're driving the business. Keep in mind that in that, part of the reason why spare parts growth-- just to be clear the difference between spare engines and spare parts growth, is more than departure growth. It is just coming from the pricing discipline.

There's a part of that is just like, okay, we are doing a much better job of managing the demand. Customer mix is a factor. We monitor the inventory situation in our MRO shops very, very carefully and we have very, very good insight into how much inventory each of our MRO partners are carrying. So, we don't see any buildup, and that's where we feel as you look between '23 and '25, we do expect the commercial business to be up mid-teens over the next two years.

Josh Pokrzywinski: The other thing I wanted to follow up on there was that price comment. Clearly, there's so much tightness in the system than definitely a board's more forward look on price. Does that tend to be sticky? At some point, hopefully, as we come into greater balance, are you going to get people knocking on your door at that point in time? Or does price tend to be fairly sticky once you get it?

Rahul Ghai: So, it is fairly sticky. Historically, we've driven price in the mid-single-digit range. That's been the historical trend. Over, of course, the last couple of years, inflation has been high, so the price increases have been higher than normal. Now, as we look forward into '23 to '25, we do expect the outlook that we have shared for 2025 in terms of $2 billion of profit growth. That factors in mid-single-digit price increase, so price increases going back to historical norms.

As inflation comes down, we do expect the price increases to come down as well. That's what's built into our outlook that we provided for '25.

Josh Pokrzywinski: Understood. I do think there is some concern lingering in the background that maybe air traffic slows just because it's been so strong. Clearly, with all the shortages in the industry, you can still grow through that, and obviously fleet age and GE's fleet age specifically falls into that. But do you need a specific flight hour or air traffic backdrop to support that '25 outlook, or is that a little decoupled from air traffic in the medium term?

Rahul Ghai: What we are expecting between '23 and '25 is kind of that mid-single-digit-plus kind of traffic growth. That's what we've built in. So, it's not the 20% that we have seen this year because we clearly expect, okay, there's a recovery in '23. We're getting back to 2019 levels. Things are stable. China is coming back, so China is a big contributor to the growth this year year-over-year.

But as we get into '24, China continues to drive overall departures. But we do expect that, hey, it's kind of in the high-single-digit range maybe for '24, maybe go down to mid-single-digits for '25. That's what's baked in here, so more normalized growth.

And then in terms of the other drivers, I spoke about the pricing, and we touched on the shop visits earlier, right? The shop visits have actually lagged behind departure's growth. So, if you look between 2019 and 2023, even though air traffic is now back to where it was in '19, the shop visits are not back. Shop visits are still trailing where they were back in 2019. So, there's a little bit of catch-up that's going to go into '24 and '25.

So, you put all of that together, that gives us confidence that services continues to grow. And then the commercial OE is going to lead that mid-teens growth because you see the demand out there for new engines. That is clearly, we said about 1,700 LEAP engines this year and then 2,000 for next year, and then growth from that point on. So LEAP engines continue to grow, and that drives the commercial growth as well.

Josh Pokrzywinski: I do want to spend a minute on LEAP here if we can. We're going to be approaching breakeven here over the next couple years. How should we think about the timing of that? I guess maybe the subpart B to the question is, competitive landscape might be changing here a little bit. Does that accelerate maybe the path toward breakeven on something like better pricing power or just higher win rates?

Rahul Ghai: So, just to level set the stage and then we can get into the recent events here. What we've previously communicated, service becomes profitable next year. And I'll come back and speak another word on why. Overall program becomes profitable in 2025, and then OE becomes profitable in '26. That's the trajectory we are on.

Why do we feel good about the services profitability for next year? A couple of things. One, we start getting into now revenue recognition shop visits, right? So far, we've been in majority quick turns. We haven't done a lot of restorative shop visits. As you get into '24, we start that, so that drives a certain amount of revenue recognition (inaudible).

As we also previously said, as we've encountered some problems and challenges on the launch, whether it's a radial drive shaft, shroud, higher than expected shop visits in the Middle East, we've been taking specific warranty reserves, so specific reserves I should say on those events.

Now, as you get into '24, the performance is getting better. We don't need to take the same level of reserves. And those costs that are coming in are going to get charged to those results. So put that together, we feel that, hey, we can drive LEAP service profitability into '24 and then it just goes from that point on. And you've seen what we said on the nx back in Paris. With the nx, our profit margins are 4x in a 10-year period. So, we're following the exact same playbook on LEAP, so the margins should grow from that point on. And we can come back if you want, on that topic.

On the recent events, it doesn't change much on LEAP for the near term. We feel we are in a good market spot right now. So, it shouldn't change much for the near term, because clearly, we've living in a supply-constrained environment, so we are trying to do the best we can to meet air framer expectations, airline expectations, so no change expected in the near term.

Josh Pokrzywinski: Understood. Then just sort of zooming out on LEAP, generationally a tough comp versus CFM56. I think that's the engine that was created by a man (ph). How do you get comfortable with the aftermarket lifecycle value there compared to LEAP? Obviously, LEAP has a couple of different designations that don't have a lot of part commonalities, certainly a more complicated engine. When will we know how that aftermarket profitability compares to something like 56?

Rahul Ghai: Yeah, so it's a great question. First, I would say, again, let's spend a minute on nx because our belief is it should follow the same trajectory. You launch a program. There are always some issues, right? And you get the performance figured out first. You get that done.

As you go deeper into the lifecycle of a product, you drive productivity when an engine comes for a shop visit. So, the turnaround times continue to shrink over time. You embed advanced technology in those shop visits as well. So nx, we did foam washing. That takes a huge amount of cycle time out of the process. And then you work on the contract restructuring, the pricing, all the other things go.

That's the playbook that we followed in nx and that is where we saw that we looked between 2012 and 2022, the profitability was up 4x. And in LEAP, it's the exact same playbook. The playbook on LEAP is going to be exactly what we did on nx. There's no reason why we should not see improvement on LEAP profitability, and that's where our strategic plan would suggest it would become profitable in '24. It improves from there in '25, and then continues to grow from that point on in terms of margins on the LEAP service revenue into the latter part of this decade.

Josh Pokrzywinski: Understood. And then maybe just a wrap of kind of the fundamental performance on Aero on supply chain. Obviously, you've mentioned several times, everyone is aware of just how tight that is for the industry. What are the areas that would be particularly helpful to improve from GE's perspective? If you just wave the want, say the Latin. Is it the forgings and castings? Is it more on the service labor? Where would you like to see the most improvement? That would be helpful.

Rahul Ghai: Yeah, listen, supply chain is-- it's across a lot of different factors. It's not in one area. If it was in one area, it would have been easy. It's across multiple fronts. It's on electronics. It's on forging and casting. It's across multiple fronts. So, I think everybody is working really hard, trying to meet the demand.

Keep in mind, I mean you look at what happened in the second quarter. Our LEAP engine output is up 80% year-over-year, right? And commercial total output up more than 50% year-over-year. And if you look at our material deliveries, material deliveries are up low double-digits. We drove a huge amount of engine output increase on a fairly decent material input increase, but not to the same level as the commercial output increase.

So clearly, there's a lot going on there where we are trying to drive LEAP in our facilities, making sure that we are reducing our cycle times, we understand what's coming. But we need that material input to grow. And in answer to your question, it needs to grow across multiple different areas. That is what we're dealing with.

I mean if you look at, we've previously spoken about the engineering help that we are providing to our vendors. I mean that number is up 50% year-over-year in the second quarter, probably in the first half, and a sequential step-up in the second half of the year. So, we are doing everything that we can to work with our vendors, making sure they get the support they need from us.

So, it's a work in progress, both on availability of skilled labor, and then on output from the tier 3, tier 4 vendors that moves up the supply chain.

Josh Pokrzywinski: Understood. And then how should we think about capital allocation for Aerospace over the next few years? Obviously, the balance sheet is in much better shape. Is there an appetite for M&A? Obviously, there's some niches like systems where we don't talk about it a lot, but these are large businesses, maybe some fragmentation out there in the market. What do you guys see? What's interesting to you?

Rahul Ghai: Listen, first I would say, as we sit here today, we feel really comfortable with the position we are in. If you look across it, there's no burning platforms and no itchy fingers, and we feel really comfortable with the position we have both on the commercial side and on the defense side. So, we feel absolutely-- and I think Larry said it at Investor Day. He said, hey, if M&A was banned, he wouldn't lose any sleep over it. And I think everybody in the company shares that view that we feel very good, and there is no driver that we have to go do something.

There are a couple of places, like we did the small acquisition called Innoveering on the defense side. It has accelerated our journey into a lot of classified programs into hypersonic, so it has taken probably a couple of years off our development cycle. So, we'll keep looking at things that make strategic sense, that make operational sense, that make financial sense. But we are at peace with ourselves, so no rush to do anything here.

Josh Pokrzywinski: Understood, maybe just pivoting over to Vernova, and I want to start first on Renewables. Obviously, a big profit improvement is expected over the next couple years and IRA certainly has a lot to do with that. But just remind folks or maybe update folks if there is anything to add. How much of the improvement you expect over the next few years is really a function of this distinguished volume price environment versus some of the work you've done on productivity or restructuring or selectivity in the portfolio?

I suspect those are the bigger buckets. But maybe give us any kind of walk that would help spell that out.

Rahul Ghai: Let's just spend a minute on Onshore and then Grid. If you look at between the two businesses, again, going from a billion and a half or so of losses last year to breakeven this year, in Onshore and Grid, I think we've said previously we're expecting low single-digit-plus kind of margins.

And the improvement is coming from three areas. One, working through the warranty issues that we found out last year. Obviously, lack of those warranty reserves is helping us this year. The second is a huge improvement in cost takeout. I gave you one example at the outset on what we are doing on the outages side in power. There's similar actions like that.

When I walked the floor with Vic the other day on what he is doing on onshore wind, I mean the projects are astounding. He's done such a good job on just driving lean and operating rhythm into everything that he does, both in the manufacturing area, and then out in the field as well.

And if you look at the headcount in that business, that headcount is down 30% year-over-year. So, a big part of the improvement over the next few years is going to be just coming down that cost curve both in the field and in SG&A. So, that's the second piece of improvement.

And the third is going to come from just the selectivity of projects that the team is picking up. So, if you look at our backlog margins, the backlog margins are in the low double-digit range now, which is a huge change from where we were. All those pieces add up. We worked through our warranty issues. We've taken the reserve. We feel good about that. We're burning through the warranty issues that are outstanding. We keep working the cost side. And then through selectivity of projects, that drives improvement in backlog margins which shows up in the P&L.

And then on the Grid side, as I'm learning the business, you learn the fact is that we're probably going through a generational improvement in the grid infrastructure in the US. Some of the projects that the team was talking about, I mean those grids have not been updated for 60 years. So, there's a huge demand out there that should help as well.

That is what turns this thing around, and Offshore, obviously we need to work through our projects. And we're in the early stages of that.

Josh Pokrzywinski: Understood. And I guess maybe the playbook of that, if there is an analogy is what you guys did in Gas Power equipment, obviously, a very squeaky wheel several years ago. Clearly, a lot of improvement has been made. But how do you think about balancing things like share and profitability now? I mean I think the view on where that market stabilizes is much clearer today than it used to be, even though that's a focus sort of services business. How should we think about the interest in growing the installed base, growing share in things like large frame?

Rahul Ghai: Yeah, so if you think about our share in power, I mean maybe it's a quarter across the world. If you remove China, we are probably a third, and the share is stable. We are the market leaders there in power outside of China. So, we're in a really good spot. The share is stable, and I think we are clearly profitable. Profitability is more important than share.

If we want incremental volume, we want incremental volume that is profitable. Specifically, I think Scott and team are focused more on the OE profitability for the projects up front. That is clearly the focus here, and not just chasing share numbers. And then that OE profitability over time translates into both the services profitability as well. That's the focus.

Josh Pokrzywinski: Understood. And then I think what's been a nice story maybe underneath the surface in gas power equipment is the strength that you guys have seen in Aeroderivatives pairs nicely with what you do in renewables. How long does that last? Does that accelerate as onshore deliveries ramp up? How should we think about that relationship perhaps over the next few years?

Rahul Ghai: So, on the Aeroderivatives, again, I'm learning the business here, but what I've learned is that it is a really nice complement to the renewable cycles and it is a competitive differentiator for us. Because our competitors do not have the same capability that we do there. That's a really good thing for us.

As you grow the renewable infrastructure, the intermittency of the power supply increases. And having Aeroderivatives helps with that quick start, the backup power, making sure the grid operates at a stable level, and the renewables kick in when they're needed. So, it's a really nice complement, so we do expect that business to continue to grow as the renewable infrastructure increases.

And right now, we are again going back to supply chain, that product is one that we are constrained on supply chain. So, we're not able to meet the demand. And it's a profitable piece for Scott and team. As we go into '24 and '25 and the supply chain constraints ease, that should be a nice lift to the business.

Josh Pokrzywinski: Understood. And then maybe to tap into another item that was a bigger legacy concern several years ago and have been nicely de-risked is on the insurance side. As that has gotten de-risked and you get the benefit of things like higher interest rates, how do you think about that long-term relationship? Have we reached this point where maybe it's safer to look elsewhere, jettison, or is it de-risked enough to where you truly can run it off internally?

Rahul Ghai: Yeah, so on insurance, listen. First, Larry and the rest of the team has done a really good job putting really good operators in place. That business is far more stable today than it was. In terms of managing risk, driving premium increases where it makes sense, all that operationally it's in a much, much better place than it was a few years ago.

We expect the last payment to go in on insurance in first quarter of next year. It's up to 1.8 billion, so that goes in. And then after that, we think we've fully funded the liabilities on insurance. We don't expect any incremental contributions.

So now to your question, we'll keep looking at options. But whether it's the whole, whether it's the parts of that, definitely we will keep looking at things. But there is not an imminent solution to that problem. It's on the table. We'll keep working it, but not imminent.

Josh Pokrzywinski: Excellent. And I see we're coming up on time, but I do have one more question. Just as we approach separation, anything that we should be watching for or anything that you're cognizant of on the timing front or any kind of milestones that we should be aware of?

Rahul Ghai: No. I think as I said at the opening, everything is on track here. The businesses are performing as expected in '23, if not better than where we were back in March. Things have improved since then, and 2024 looks good, so businesses are stable, improving. The balance sheet capacity has improved with everything that we are doing. Legal entity separation is on track, so everything looks good for early 2024.

Josh Pokrzywinski: Excellent. Rahul, I see we're at time. Thank you for the time. Appreciate you joining us for the conversation.

Rahul Ghai: Yeah, thank you.

Josh Pokrzywinski: Thank you.