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RTX.N - Q3 2020 Raytheon Technologies Corp Earnings Call

EVENT DATE/TIME: OCTOBER 27, 2020 / 12:30PM GMT

OVERVIEW:

Co. reported 3Q20 adjusted sales of \$15b and GAAP EPS from continuing operations of \$0.10. Expects 4Q20 sales to be \$16.2-16.4b.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Raytheon Technologies Third Quarter 2020 Earnings Conference Call. My name is Joelle, and I'll be your operator for today. As a reminder, this conference is being recorded for replay purposes.

On the call today are Greg Hayes, Chief Executive Officer; Toby O'Brien, Chief Financial Officer; and Neil Mitchill, Corporate Vice President, Financial Planning and Analysis and Investor Relations.

This call is being carried live on the internet, and there is a presentation available for download from Raytheon Technologies' website at www.rtx.com.

Please note, except where otherwise noted, the company will speak to results from continuing operations, excluding net nonrecurring and/or significant items and acquisition accounting adjustments, often referred to by management as other significant items.

The company also reminds listeners that the earnings and cash flow expectations and any other forward-looking statements provided in this call are subject to risks and uncertainties. RTC's SEC filings, including its forms 8-K, 10-Q and 10-K, provide details on important factors that could cause actual results to differ materially from those anticipated in the forward-looking statements.

(Operator Instructions) With that, I will turn the call over to Mr. Hayes.

Gregory J. Hayes - *Raytheon Technologies Corporation - President, CEO*

Okay. Thank you, Joelle, and good morning, everyone. For those of you following along, we're on Slide 2 of the webcast, just to spend a minute talking a little bit about the current environment.

We've now passed the 6-month mark as Raytheon Technologies. And I would tell you, I'm proud of the job the team has done with the integration despite the fact that most of the work has to be done remotely. We obviously continue to operate in the midst of one of the most difficult times the industry has seen, but we remain focused on delivering for our customers and protecting the health and safety of our people.

Through the pandemic, we continue to invest in technology and innovation that's going to drive long-term growth while also maintaining a disciplined approach to capital allocation and implementing tough but necessary cost reductions, including some structural cost actions that we'll talk about later.

Notwithstanding that environment, we delivered solid results in the quarter, and we're pleased with the progress we've made with our merger integration and the decisive actions that will position us to emerge from the pandemic in a position of strength. Sales for the quarter were in line with expectations, and adjusted EPS and free cash flow were better than expected. In fact, free cash flow was significantly better than expected at about \$1.2 billion.

On the defense side, backlog remains robust, over \$70 billion. We've had exceptional bookings this year, and we expect both of our RIS and RMD businesses to end 2020 with record backlog. At the same time, we continue to focus on what we can control. Let me give you just a quick update on our cost actions and our cash actions as well as some of the merger integration and synergies. And while we're firing on all cylinders across a number of fronts, we're always looking to where we can do more.

On the cost side, so earlier this year, we've implemented cost reductions that gave us about a \$700 million benefit in the quarter. Even more importantly, we took cash conservation actions that saved us \$1.9 billion in the quarter. Both of these are what -- ahead of what we communicated last quarter, and we remain confident that we'll realize the full benefit of all of these actions by year-end. I'll go into more detail on the next slide.

Regarding the merger, our cost and revenue synergy activities are progressing quite well. The team is working nearly 550 synergy projects. During the quarter, we achieved about \$65 million in gross cost synergies, bringing us over to \$100 million in the first 6 months. And we now see about \$225 million of gross synergies this year, up from our early estimate of \$200 million. We remain confident that we'll achieve at least \$1 billion in gross run rate cost synergies by 2024.

On the Rockwell Collins side, Collins Aerospace synergy activities also continue. We achieved another \$40 million of synergies in this quarter, which brings us over \$130 million year-to-date and over \$430 million since the deal closed in November of 2018. And we're quickly approaching our \$600 million synergy target. And we remain on track to reach at least another \$150 million for this year, and these are in addition to the \$225 million of gross RTX synergies this year. On the revenue synergy front, we continue to see significant opportunities to leverage our collective technologies to drive incremental growth, and we're progressing here, as you would expect.

And finally, a couple of comments on some recent divestitures. We recently completed the divestitures of Collins' Military GPS and Space ISR business, which resulted in net proceeds of about \$2 billion, further supporting our strong liquidity position and contributing to the \$10 billion of cash that we have on hand at the end of the quarter.

You also saw the announcement yesterday that we reached an agreement to sell our Forcepoint business. We expect that deal to close in the next 3 to 4 months, and gross proceeds from that transaction should be about \$1.5 billion. Again, great cash position, great liquidity.

Okay, let's talk a little bit about cost. Slide 3. Maybe first on the market. So on the commercial aero front, our view remains unchanged. We don't expect commercial air traffic to return to 2019 levels until at least 2023, and that's, of course, depending upon the timing of a widely distributed vaccine. In the near term, we expect a gradual recovery of commercial air traffic, particularly given the recent spike in global cases.

So here's an update about what we're doing about it. As you know, we set aggressive targets in the first quarter to reduce cost by about \$2 billion and to take actions to conserve about \$4 billion of cash. We're taking the difficult but necessary actions to reduce headcount at both Collins and Pratt. We'll reduce about 20% of our commercial aero headcount; that's about 15,000 positions. We're also taking out about 4,000 contractors. These are primarily engineering contractors, so a total reduction of roughly 19,000 folks. Then of course, on top of that, there's another 1,000 folks that will be leaving as a result of the merger synergies, and that's mostly corporate. So about 20,000 positions have been eliminated.

Just maybe on the opposite side of that, though, in our defense businesses, we are hiring in targeted areas to support the growing businesses, primarily on the engineering front. Importantly, we're also actively seeking out additional structural cost-reduction opportunities. We are turning our attention towards ensuring we optimize our footprint, accelerate transitions from high- to low-cost locations and permanently reduce overhead cost.

One example I've shared, I've challenged the team to think very differently about how we work in the future. And when we came together as RTX, our original goal was to reduce and consolidate office space by about 10% or about 3 million square feet. I now think we could see upwards of 20% to 25% reduction in square footage. That's going to be a huge savings.

Additionally, last week, Pratt announced a new vertically integrated, highly automated turbine airfoil production facility to fulfill future GTF and F135 demand. That facility will be located in Asheville, North Carolina. This is going to be a greenfield facility that will modernize and transform Pratt's operations with cutting-edge technology while significantly reducing structural costs and enabling operational efficiencies through automation, value stream, colocation and best-in-class lean processes. Once fully operational, we expect to see annual run rate savings of about \$175 million from this investment.

These are just a couple of examples of the structural actions we're taking to position ourselves for long-term success. Additional projects are also under evaluation, so we're not done yet. At the same time, we're not losing sight of execution across our business. Let me give you a couple of examples.

First, we're shifting some of the production of our circuit cards from our Andover, Massachusetts facility to Collins Aerospace's circuit card center of excellence in Coralville, Iowa. This allows us to better meet our customer commitments at a lower cost and balances demand between our facilities.

Secondly, we're strategically utilizing available shop capacity to upgrade the GTF fleet to the latest configuration to ensure our customers' fleets are healthy and well positioned as we exit the year and demand slowly returns. So overall, despite near-term uncertainty on the commercial aero side, I'm very confident in the long-term growth potential of the company.

Our defense portfolio is resilient with businesses that are aligned with the U.S. National Defense Strategy and focused on higher-growth, higher-technology areas. And the long-term fundamentals of the commercial aerospace remain intact. We have unique advantages as a result of the merger, and I'm confident we'll be able to drive significant value for our customers and our shareowners.

So with that, let me turn it over to Toby to take you through the financial results in a little bit more detail. Toby?

Anthony F. O'Brien - Raytheon Technologies Corporation - Executive VP, CFO

Okay. Thanks, Greg. I'm on Slide 4. While commercial aero headwinds persisted in Q3, our performance was generally better than we had expected.

Adjusted sales were \$15 billion, up about \$400 million sequentially over Q2, including the stub period. Adjusted EPS was \$0.58, better than our expectations, driven by acceleration of our cost mitigation actions and continued strength of military volume at Pratt and Collins. The lower effective tax rate in the quarter also contributed to a few cents of improvement.

On a GAAP basis, EPS from continuing operations was \$0.10 per share, down year-over-year and included \$0.48 of net nonrecurring and/or significant items and acquisition accounting adjustments. This includes a net gain on dispositions of \$0.17 per share, which was more than offset by \$0.27 of acquisition accounting adjustments primarily related to intangible amortization, \$0.26 related to charges due to the current economic environment driven by the COVID-19 pandemic and \$0.12 of restructuring.

Free cash flow of \$1.2 billion was better than expected and included about \$600 million of merger costs, restructuring and tax payments on divestitures. The better-than-expected cash flow was driven primarily by the timing of collections at RMD as well as in our commercial aero businesses and accelerated realization of our cash conservation actions, including inventory reductions at Collins.

Moving to Slide 5. Let me share with you a few data points that demonstrate the resiliency of our portfolio. Bookings at RIS and RMD have been exceptionally strong over the last year, as demonstrated by the trailing 12-month book-to-bill ratios where both businesses are well above 1, positioning us for continued growth across our franchises both domestically and internationally. About 40% of the backlog at these businesses is for international customers. And military sales growth at Collins and Pratt continues to be very strong with organic sales growing 8% and 11% in the quarter, and that's on top of 10% and 13%, respectively, in the first half of the year.

On the commercial aero side, we saw modest improvements in aircraft utilization across the fleets powered by Pratt's GTF and V2500 engines. While certainly down considerably from prior year levels, it's encouraging to see a large number of our engines in active service. The commercial aero recovery clearly still has a long way to go, but we are well positioned to capture improvements and utilization of the world's narrow-body fleets in addition to the continued strength of our defense businesses.

With that, I'll hand it over to Neil to take you through the segment results, and I'll come back and share a bit more perspective on the rest of the year. Neil?

Neil G. Mitchell - Raytheon Technologies Corporation - Corporate VP of Financial Planning & Analysis and IR

Thanks, Toby. Starting with Collins Aerospace on Slide 6. Adjusted sales were \$4.3 billion in the quarter, down 34% on an adjusted basis and down 33% on an organic basis, driven primarily by the adverse impact of COVID-19 on the industry.

By channel, commercial OEM sales were down 44%, driven principally by the impact of COVID-19, the continued 737 MAX grounding and the anticipated declines in legacy programs. Commercial aftermarket sales were down 52%, driven by a 51% decline in parts and repair, a 67% decline in provisioning and a 44% decline in modifications and upgrades. Partially offsetting the headwinds in the commercial channels, defense sales were up 4% on an adjusted basis and up 8% organically with strength across many of our key platforms and product lines.

Adjusted operating profit of \$73 million was down \$1.2 billion from prior year and slightly better than our expectations for the quarter. Cost management actions, including lower E&D, continued synergy capture and drop-through on higher defense sales, were more than offset by lower commercial OEM and aftermarket sales and fixed cost headwinds. Looking ahead to the fourth quarter, we see Collins' fourth quarter sales and operating profit in line with Q3. And for the year, organic military sales are now expected to be up high single digit.

Shifting to Pratt & Whitney on Slide 7. Adjusted sales of \$3.8 billion were down 34% on an organic basis and down 28% on an adjusted basis, also driven by the adverse impact of COVID-19 on the industry. Commercial OEM sales were down 30%, driven by lower deliveries across Pratt's large commercial engine and Pratt Canada platforms, with the exception of the PW800 which saw a slight growth in the quarter.

Commercial aftermarket sales were down 51% in the quarter. Growth in the GTF aftermarket volume was more than offset by the impact of a reduction in legacy large commercial engine shop visit inductions of about 55% and a 37% reduction in Pratt Canada shop visits.

Joint Strike Fighter production continues to drive sales growth at Pratt's military business. Military sales were up 11% on higher aftermarket sales across key platforms, including F117 overhauls and increased F135 production volume. Pratt incurred an adjusted operating loss of \$43 million, down \$563 million from prior year. Significant aftermarket volume reductions and fixed-cost headwinds more than offset cost containment measures, including sizable E&D and G&A reductions and drop-through on higher defense sales.

Looking to the fourth quarter, we expect a slight sequential improvement in Pratt sales from Q3 with operating profit also up slightly. For the year, military sales are now expected to be up low double digits.

Turning now to Slide 8. RIS reported sales were \$3.7 billion, down approximately 2% versus prior year on a pro forma basis, as expected. Sales in the quarter were impacted by expected declines in the Warfighter FOCUS program, which represented 3 points of sales headwind, as well as the divestiture of the Airborne Radios business, which represented about 0.5 point of sales headwind in the quarter. Reported operating profit in the quarter was \$348 million. Keep in mind, the percentage of completion reset at the merger date continues to impact the compares for both sales and operating profit at the legacy Raytheon businesses.

Looking at Q3 on a sequential basis, including the premerger stub period, sales at RIS grew approximately 4%, and ROS improved 10 basis points to 9.5%. RIS had bookings in the quarter of approximately \$2.9 billion, resulting in a backlog of over \$18 billion. Significant bookings included approximately \$930 million on classified programs and a booking of approximately \$175 million to perform operations and sustainment for the U.S. Air Force Launch and Test Range System. We expect the full year pro forma book-to-bill ratio to be above 1.0, resulting in a record year-end backlog.

As we look at the remainder of the year for RIS, we expect sales to be at the low end of the Q2 to Q4 sales range previously provided or closer to \$11 billion, in part due to cost savings in the business as well as some later timing on awards. Operating profit for Q2 through Q4 is expected to be within the prior outlook range between \$1.085 billion and \$1.115 billion with overall margin improvement as a result of cost savings within the business.

Now turning to Slide 9. RMD reported sales were \$3.8 billion, down approximately 2% versus the prior year on a pro forma basis. As previously disclosed, in the prior year's quarter, RMD sales included an inventory liquidation on an international air and missile defense system program, which represented about 3 points of sales headwind. Reported operating profit was \$453 million. And as I touched on earlier, both sales and operating profit in the quarter include the impact of the EAC reset as a result of the merger.

On a sequential basis, including the premerger stub period, RMD's Q3 sales were in line with Q2, and ROS improved 80 basis points to 11.9%. RMD bookings in the quarter were approximately \$2.6 billion, resulting in a backlog of over \$31.5 billion. Significant bookings in the quarter included approximately \$185 million to provide TPY-2 radars to the Kingdom of Saudi Arabia. We also expect RMD's full year pro forma book-to-bill to be above 1.0, also resulting in a record year-end backlog.

And looking at the rest of the year for RMD, we see Q2 to Q4 sales more in line with the low end of the prior outlook range, so closer to \$12 billion. Operating profit for Q2 through Q4 is expected to be within the prior outlook range between \$1.450 billion and \$1.480 billion as, again, we are seeing cost reductions and synergy savings materialize.

So let me turn it back to Toby to provide some color on the rest of the year.

Anthony F. O'Brien - Raytheon Technologies Corporation - Executive VP, CFO

Okay. Thanks, Neil. I'm on Slide 10. Let me give you a little perspective on the current environment as we look to close out the year.

As we've seen throughout the year, military program growth remains robust, both domestically and internationally, and is contributing to our defense sales growth and our defense backlog. This backlog provides the foundation for future growth as we look ahead.

As Greg mentioned, we also continue to execute on our previously initiated actions, including both synergies from our recent merger and the continuation of the Collins integration synergies. And we're well ahead of the targets we set in Q1 for our cost and cash actions with only 35% of our cost and about 25% of cash actions to go in the fourth quarter.

Turning to the macro factors. Commercial aero end markets remain uncertain. We saw a slight improvement in global travel in the third quarter, and our Q4 expectations anticipate a slight improvement above Q3 levels. We are continuing to track air traffic trends and the condition of airlines on a daily basis, but the recovery remains slow.

With that said, let me tell you how we see Q4. As we think about what this means for our business as a whole, we continue to see a gradual recovery in our commercial aero businesses beginning in Q4, combined with an expected ramp at RIS and RMD, contributing to Q4 company sales of between \$16.2 billion and \$16.4 billion.

Moving to adjusted EPS. The continued defense growth, gradual demand recovery in commercial aero and realization of additional synergies and cost actions are expected to drive EPS of \$0.65 to \$0.70 per share.

Just a couple of things to keep in mind. We have provided an updated outlook on some below-the-line items as well as an update to the RIS and RMD outlooks in the webcast appendix. Also keep in mind that the fourth quarter will include about a \$0.04 impact due to the incremental expenditures associated with the implementation of COVID protocols across our businesses, bringing the full year cost to about \$0.16 or in line with our previous expectations.

Now turning to free cash flow. We continue to expect full year pro forma 2020 free cash flow of roughly \$2 billion. This includes an outflow of about \$1.2 billion for merger cost, restructuring and tax on dispositions, as we have previously discussed. In summary, we expect the fourth quarter to be another challenging quarter for our commercial aerospace segments but continue to expect strong growth from our defense businesses.

So with that, I'll hand it back over to Greg to wrap things up.

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

Okay. Thanks, Toby. So first of all, let's just talk about priorities, and then we'll get to Q&A. Obviously, first and foremost, it's the health and safety of all of our employees, and keeping those people safe is job #1. And I'd be remiss if I didn't say thank you to all those folks who continue to come to the office, come to the factories, meet our customers' commitments, the yeoman's work and really a shout-out to the great work that's been done over these last 6 months.

Of course, customers remain at the heart of everything we do, and it's about customer-centricity, and solving our customers' most difficult technical challenges remains our mission. And of course, keeping the supply chain healthy and robust is essential.

On top of that, of course, though, we need to continue to invest in technology and product innovation. Even in these difficult times, we continue to spend money on next-generation technology, both on the commercial aero and on the defense side of our business. Of course, we're going to continue to execute on the integration and deliver the synergies that we've committed to, the \$1 billion-plus that we'll see at the corporate offices from the Raytheon-UTC merger as well as the \$600 million of synergies that we've committed to from the Rockwell Collins acquisition.

We're also, of course, going to continue to drive structural cost reduction. We've talked about a couple of those already, but there are more out there, and we're going to continue to drive that as we always do. And lastly, we're going to remain disciplined in our capital deployment and maintain strong liquidity. Obviously, with \$10 billion on the balance sheet at the end of the quarter, we feel very good about where we are, but we're going to remain disciplined. We do remain committed, though, to the \$18 billion to \$20 billion of capital return to shareowners during the first 4 years of the merger, and we see that, that -- a path to that very clearly today.

So with that, let's stop. And Joelle, let's take some questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question will come from the line of Peter Arment with Baird.

Peter J. Arment - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Maybe this is just for Toby; and maybe, Greg, you may want to make a comment about it. Just trying to get a clarification on the unfavorable contract adjustment at Pratt & Whitney, I think, the \$543 million. Can you give us maybe some more details on that and just what we expect if this is related to kind of power-by-the-hour contracts, how we see that playing out?

Anthony F. O'Brien - Raytheon Technologies Corporation - Executive VP, CFO

Sure. So there were 3 pieces to this, Peter, all of them were non-cash. So the charge was all non-cash related. They were all distinct and unique to specific circumstances. In one case, we secured a longer term, which will end up resulting in more predictable efforts on our part and a longer contract, which extends the life of that particular fleet. So that's good for the customer and good for us.

The second one here, we revisited our estimates of flight patterns in light of the COVID-19 pandemic related to one customer and made an adjustment related to that. And then the last part of this, we took an impairment charge on some assets associated with the program where we've seen the development pushed out to the right or delayed. So 3 different situations, but all, in total, all non-cash related.

Operator

Our next question comes from Carter Copeland with Melius Research.

Carter Copeland - Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense

Greg, correct me if I heard you wrong, did you say 20% to 25% square foot reduction? Did I get that number right?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

That is correct. We've got about 31 million square feet of office space. The original goal is to take about 10% of that out as part of the merger. We think we can more than double that with kind of the new working arrangements that we've all become accustomed to. So the office of the future, as we call it, will be a mix of both office as well as people that will be working remotely.

Carter Copeland - Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense

So if I think about that across the segments, obviously, I guess, as part of the evolution and the cost reduction, it would be much larger than that in the commercial side of the aerospace businesses, but it seems like a big number.

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

It seems like a big number, Carter. And look, the fact that we had 31 million square feet of office space seemed like a really big number to me. But at the same time, for these last 6 months, as I've toured the country and visited facilities where we've got literally a handful of folks working there and everybody else is being efficient working remotely, it became very apparent we don't need all the space. And I think the ability to work remotely with the technology that we have without losing productivity is essential in our go-forward plan.

So there is a significant amount of cost to take out. Obviously, we're going to start with our leased offices, and we've got a plan over the next 5 years to reduce that significantly. And again, that's easy cost savings in my mind.

Carter Copeland - Melius Research LLC - Founding Partner, President and Research Analyst of Aerospace & Defense

And so the Pratt -- that first one on the Pratt consolidation and the new facility there is -- so that's just consolidation of that footprint, not in-sourcing efforts or anything like that, just pure cost reduction?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

No. There's a whole series of things that Pratt is doing associated with this new facility we're building down in North Carolina. Some of it will be in-sourcing work from the supply chain. Some of it will involve moving work from high-cost to lower-cost locations. Again, this is a multiyear program, but it's absolutely essential. We need the capacity because, eventually, demand will return. And I think by the time this comes online in late 2023, we should see a return to kind of normalcy in commercial aerospace, and Pratt will be well positioned with a much lower cost, much more automated production facility.

Operator

Our next question comes from Ron Epstein of Bank of America.

Ronald Jay Epstein - BofA Merrill Lynch, Research Division - Industry Analyst

Maybe a bigger strategic question, following up on your last comment. If you're thinking about the market getting back to some level of normalcy, like '23, '24, something like that, and you look at your own balance sheet and you compare it to that of your competitors, particularly in the engine business, how are you going to use that balance sheet as we go into the recovery to your advantage? If you look at Rolls, they seem kind of impaired. GE is a shadow of what they once were. So Pratt is sitting here with the strongest balance sheet in the industry. So how do you think about that?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

So I think there's a couple of thoughts, Ron. Obviously, we're not going to go out and buy -- we don't need to do any big M&A. I'll say that first and foremost. We will be opportunistic. There are a few things out there from a technology standpoint that you'll see us doing here. But those are, I would say, relatively low dollar types of transactions. It really just fills in some blanks in the canvas.

The next opportunity, I think, is going to be to go back to share buyback. I think you'll see that start up again next year. We think with the balance sheet that we've got, with the cash on hand, with the sale of Forcepoint now, there will be plenty of cash to start that back up next year.

And if you think about the other thing we're going to try and do on the Pratt side is we're going to continue to try and gain market share. And I don't mean to be reckless about it, but over the last 1.5 years or so, we've picked up about 12 points of market share. We went from 43% to about 55% on the A320 family. And we think that's a reflection both of the technology as well as the efficiency that you're getting with the GTF engine.

So we're going to use the advantage that we have to continue to gain market share, and we're also going to continue to invest. And I think, Ron, as you know, you have to invest for the long term. It takes 10 years to develop an engine. It takes years and years to develop new radar systems, new weapon systems. And so we have to stay on the leading edge of technology. I want to use the dollars that we have to continue to strengthen the leading position we have in those markets.

Operator

Our next question comes from Doug Harned with Bernstein.

Douglas Stuart Harned - Sanford C. Bernstein & Co., LLC., Research Division - SVP and Senior Analyst

I wanted to understand a little more about how you're thinking about the trajectory on the aftermarket at Pratt because, I mean, in that adjustment that Toby just talked about there, there's, like you said, \$400 million in there related to pandemic-related cost reduction -- cost adjustments.

So when you think about this going forward, given that there is a fair amount of uncertainty around how we're going to see this recovery play out, how do you think about these adjustments? When are they appropriate to be adjustments? And when do they become more normal issues if this extends for 2 or 3 years?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

So Doug, let me be clear. As we took a look at all of the contracts that Pratt has, all the long-term contracts that Collins has this quarter, these 3 stood out as, I would say, things that needed to be adjusted based upon our view of the kind of return of normalcy to commercial air traffic. So we've taken a look at every -- I don't expect there's going to be a lot more out there like this. This is very unusual, the size of these adjustments. But as you know, these -- some of those contracts were pretty onerous. This is some of the original, early GTF contracts that were impacted by the pandemic. And with the downturn in traffic, it was just natural to have to take these adjustments.

The fact is we don't think you're going to see it return to normalcy until probably mid-2023 at the earliest in terms of passenger traffic. And as a result, you're just not going to have the number of flying hours that we had expected. If it gets better, there might be upside on some of these contracts. We think we've covered the downside by all of these adjustments that we've made, the same with the impairments that we took last quarter at Collins. Again, we think we have properly sized all of these now for what we believe to be the shape of the recovery. And it's clearly not a V, right? This is going to be a long, slow recovery.

If you think about it, Pratt -- let's see, I'm trying to think. Pratt's shop visits in the quarter, right, down about 55%. Now that's a little bit better than what we saw in the second quarter, which is down 64%, but that's going to take a long time to get back to the 2019 levels. And of course, all that is what plays into these contract adjustments.

Douglas Stuart Harned - Sanford C. Bernstein & Co., LLC, Research Division - SVP and Senior Analyst

So is it fair to say that your sense is that even though we may have a tough Q4 ahead of us, Q4, maybe even Q1, that the adjustments that you've taken now, we're not likely to see another round of those, given what you're seeing in the market?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

Well, I can never say never. But I would tell you, based on the assumptions that we've made in terms of this very slow recovery of air traffic -- and again, our models pretty much mirror what IATA has been doing in terms of the recovery trajectory. Obviously, what's going on right now with the resurgence of COVID is pressure testing those. But even with this, I don't know, second or third wave, whatever you want to call it, we still feel pretty comfortable with the models that we've used to make these contract adjustments, to look at the impairment analysis are all pretty rock solid.

Toby, any...

Anthony F. O'Brien - Raytheon Technologies Corporation - Executive VP, CFO

No, I think that's right, Greg. I mean, Doug, we have -- we're very comfortable with where we are, what we've taken adjustments on, as Greg just described. I'll just reiterate his point. We can never say never because, as an example, in our assumptions here, right, we have an assumption, as an example, that there will be a vaccine at a point in time. And obviously, if that pushes right, keeps pushing right and people don't feel comfortable back to flying, then we'd have to revisit things.

But the teams have done a good job working with our commercial customers to assess their situation. And again, as Greg said, we believe we've captured everything that we know about here through the Q3 results.

Operator

Our next question comes from Sheila Kahyaoglu with Jefferies.

Sheila Karin Kahyaoglu - *Jefferies LLC, Research Division - Equity Analyst*

My question was on Collins. How do we think about 1% margins in the quarter? And perhaps the contraction relative to peers is much steeper. And I appreciate there's some idle facility costs in there, too. Can you maybe bridge the profit decline today and how we think about that improvement back to high teens eventually?

Neil G. Mitchill - *Raytheon Technologies Corporation - Corporate VP of Financial Planning & Analysis and IR*

Sheila, thanks. It's Neil. How are you doing? We're obviously watching the Collins margins. There's a lot of great cost reduction going on within the business, taking E&D down, obviously, the headcount merit, furloughs. But I think when I think about the Collins margin story, this is really -- what you're seeing here is really strong aftermarket drop-through that's not occurring right now. So we feel very good about the cost actions that are in place at Collins and that when that volume does return, and remember, typically, that's about a 6-month lag from kind of when traffic recovers, we should start to see really good incremental margins at the Collins business. But I think they're taking all the right actions right now within their portfolio to address the immediate cost headwinds. We should see that come back as the market comes back.

I don't know, Toby, if there was more that you wanted to add there.

Anthony F. O'Brien - *Raytheon Technologies Corporation - Executive VP, CFO*

No, I think you hit that right on. I mean we saw 55% decrements at Collins in Q2, right? And that's taken into account, as Neil said, the cost actions that we've implemented to date. And it's a reflection of the strength of that aftermarket and how strong the business units within Collins are and 100% reinforce what Neil said. We should see the opposite on the upswing. There may be a lag, that 6- to 9-month lag that Neil talked about. And the mix of business, right, the mix of the revenue could skew things in any given quarter. But generally speaking, we expect to recapture that on the upside.

Gregory J. Hayes - *Raytheon Technologies Corporation - President, CEO*

Yes, Sheila, I would just make 2 other points. Obviously, the aftermarket at Collins is very profitable. I think everybody knows that, especially on the software side. Obviously, we don't have the ADS-B mandates this year, which is, again, a big chunk of the margin degradation.

The other thing, I just want to emphasize what Toby said, we have been burning down backlog at Collins. And so even though the aftermarket is down, I don't know, 50%, 55% here, we have been burning down backlog, getting past due. I don't expect we're going to see an upturn in aftermarket until sometime next year. Even if we start to see a recovery in the fourth quarter in commercial air traffic, which is still a question mark, I don't think anybody should be focused on 2021 to see a big uptick in commercial aftermarket, primarily at Collins because there's a lot of excess material out there. There's a lot of folks still trying to do what they can to minimize costs.

So this is not a 1-quarter, 2-quarter problem. It's going to be here for a while. But it is exactly as we had laid out in our outlook. So I wouldn't worry about it other than the fact, everybody just needs to be aware, this is not a quick recovery in the aftermarket.

Operator

Our next question comes from Myles Walton with UBS.

Myles Alexander Walton - UBS Investment Bank, Research Division - MD & Senior Analyst

You talked about the structural cost, and you have Slide 3 in the deck. And maybe it's just me, but I'm trying to reconcile the cost initiatives to long-term structural savings. And I know you did that with the Pratt turbine facility. Is there a way that you can sort of simplify all the actions you're doing and talk about it in the construct of run rate savings that you'll be able to benefit from on an ongoing basis versus temporary cost reductions that come back into the system as you release temporary furloughs or pay merit deferrals and things like that?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

Myles, you actually hit on a good point because a chunk of those savings this year are, indeed, I would say, onetime cost savings. For instance, the furlough days, I think Pratt is taking 15 furlough days. Collin is a similar number this year. Those types of cost reductions do, in fact, become headwind as we think about next year.

Now some of the other things, so there's the merit deferral, there's the furloughs, again, all those headwinds into next year. But at the same time, as I think about, we reduced about 20% of the headcount on the commercial aero side this year so far. About half of that, I would say, will eventually come back as volume comes back.

The key, as you talk to both Chris Calio at Pratt and to Steve Timm at Collins Aerospace, is we got to keep the other 50% from coming back. And that's what's going to give us leverage on the upside when we do indeed see a return to normalcy in air traffic. So again, some headwinds next year from some of these temporary cost reductions, but there is long-term structural cost reductions.

Is it primarily overhead, as you would expect, right? This is kind of taking folks out of procurement, taking layers of management out, reducing overhead really across the board. Again, all of it should lead to, long term, a much more efficient organization there.

Myles Alexander Walton - UBS Investment Bank, Research Division - MD & Senior Analyst

Is it maybe half of the cost actions -- cost initiatives are structural?

Anthony F. O'Brien - Raytheon Technologies Corporation - Executive VP, CFO

So I think the thing I'd add in, Myles, Greg focused a lot on the labor-related or employee-related cost there, right? Remember, we had a bucket around E&D reduction and also discretionary costs, right? So I think those 2 elements of our \$2 billion, I think you'd expect that we'd be able to sustain those so that there'd be no headwind or tailwind. Generally speaking, in 2021 relative to those 2 buckets, we would expect a favorable -- in 2021, we'd expect, related to all the employee-related actions when you net the puts and takes, maybe \$100 million, \$200 million of favorability or tailwind, all else equal in 2021.

Operator

Our next question comes from Kristine Liwag with Morgan Stanley.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

Greg, with cash generation stable, how do you think about investing in next-generation technology and sustainability? I mean after COVID-19, carbon emissions in aviation would still be an industry issue. How do you think of investments in capabilities like hydrogen-powered aircraft, especially with Pratt's long history with hydrogen?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

Yes, that's actually a great question. Hydrogen, obviously, is a zero-emission fuel. It's got better power density than Jet A. It does have a little bit of a storage problem on aircraft. You can't put hydrogen tanks into the wings of an aircraft. So what you're talking about from a commercial aerospace standpoint is probably a 2035 or so entry into service of a hydrogen-powered aircraft. We continue to work with that.

For us, on the engine side, whether you're burning Jet A or whether you're burning hydrogen, it's not that different a technical problem. And I think we're pretty well positioned there to help with the aircraft OEMs as they explore this. Airbus has an active program on hydrogen. I suspect Boeing will as well. But again, we're sitting here in 2020. That is a 15-year time horizon. We're going to continue to invest because, as you say, sustainability will be an issue.

Now the GTF went a long way, right? There was a 16% better fuel burn, but 50% better on the emissions. Even that, we recognize we've got to do better. So we're going to invest in hydrogen. We're also going to invest in hydrogen on the defense side because I think what you'll see is VOD money will come faster than some of the money that the commercial OEMs want to invest in this. So we're well positioned. We've got the technology, and I think it is the future of aviation, but it's a ways out.

Operator

Our next question comes from Robert Stallard with Vertical Research.

Robert Alan Stallard - Vertical Research Partners, LLC - Partner

Toby, a technical question for you. Obviously, you did better than expected on the Q3 cash flow, but you didn't raise the cash guidance for the year. So I was wondering if you could explain some of the moving parts there.

Anthony F. O'Brien - Raytheon Technologies Corporation - Executive VP, CFO

Yes. So as Greg mentioned and I did, I mean, we're really pleased with what the team has been able to do around cash flow in particular. The favorability here that we saw in the quarter, primarily timing-related at RMD and Collins related to customer collections. And we also saw some inventory reductions ahead of schedule, primarily at Collins, and a little bit of favorability on the timing of some cash tax payments. But again, real strong performance.

When we think about the year, and we maintain the \$2 billion, as you said, we think we have some flexibility there, some opportunity, again, timing-related around collections. We may be looking at potentially funding a discretionary pension contribution that we're considering and still be able to deliver the \$2 billion in the pro forma free cash flow. So we're feeling good about it for the year, highly confident in delivering that along with some of the flexibility that I just mentioned.

Operator

Our next question comes from David Strauss with Barclays.

David Egon Strauss - Barclays Bank PLC, Research Division - Research Analyst

I guess, Greg, first of all, any sort of update on the MAX? When do you expect to start shipping there? And a follow-up on cash flow. I think, Greg, you had previously mentioned in some public appearance that you expect significant growth in adjusted earnings next year. How are you thinking

about cash flow next year? Once you add back the \$1.2 billion to \$1.4 billion of onetime costs that are running through cash flow this year, would you expect free cash flow to actually grow next year off that base?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

All right. Well, let me start with the MAX, and we'll have Toby take you through your cash question. Although just to be clear, we're not going to give guidance on 2021 today. You guys will have to wait as we sort through all this. But as far as the MAX goes, I think we have delivered all the black label software. That's all been installed. Now you saw Europe has already granted the certificate back on the MAX and the return to flight. We expect we'll see here in late November, early December, the U.S. airlines start to return MAX to service. All of that is very good news, I think, in the long term.

It's not going to have a huge impact on Collins next year. As we said, we've delivered most of the inventory associated with the ramp-up next -- for next year's production. I think right now, we probably have, I don't know, 80% or so of the inventory already delivered to Boeing to support 2021 production. So you'll see a gradual ramp-up in 737 at Collins, but it's pretty small in the back half of the year.

Anthony F. O'Brien - Raytheon Technologies Corporation - Executive VP, CFO

So on cash, David, a couple of things, right? Just to reinforce, we feel good about the ability of the business to generate cash flow as we work up the recovery curve here in the pandemic. And as Greg said earlier, we remain committed to the \$18 billion to \$20 billion of cash being returned to shareholders. That said, at a high level, yes, we would expect 2021 cash to be better than this year.

But that said, without giving you a number per se, let me give you a couple of the moving pieces just for folks to think about for 2021. So kind of along the lines of Myles' question about the cost actions, the majority of the savings related to the planned cash actions this year, we think, are sustainable for next year, right? So kind of a push, if you will, on a year-over-year comparative basis.

That said, we will have some nonrecurring cash items of that \$1.2 billion to \$1.4 billion. There could be \$500 million to \$600 million of that, that would extend next year. That would be a headwind. The way we're thinking about CapEx, we have a goal to keep it on an operational basis similar levels as 2020.

I just mentioned that given the strength of our cash flow this year, we maybe have some flexibility and are considering a discretionary pension contribution. And in part, pension, while it will still be cash flow positive next year, it won't be as positive there. There is, call it, \$850 million of headwind due to higher required contributions that, again, depending upon how we see this year playing out, we may address this year. And we will see some incremental spend on the structural actions related, in particular, to a couple of things. Greg mentioned about the new facility and how we're thinking of our office space as well as synergies. Again, that could be \$0.5 billion in that ballpark there.

From a working capital point of view, we would expect and do expect improved turns in 2021 where we believe we're going to be able to sustain current levels of working capital until we see the volume start to recover. So still a lot of moving pieces. And of course, the other thing here, we've had a really strong year in cash on the defense side of the house. Some of that is timing. So we're going to have to factor in how sustainable that is over the 2021 time frame. And of course, again, probably the biggest variable here is the shape of the recovery and how the volumes come back and the related cash flow. So still a lot of moving pieces here. And as Greg said, we'll quantify all this here on our Q4 call in January.

Operator

Our next question comes from Robert Spingarn with Credit Suisse.

Robert Michael Spingarn - *Crédit Suisse AG, Research Division - Aerospace and Defense Analyst*

Toby, I just wanted to follow up on what you're talking about with cash flow and maybe set a base on the defense side, if we could shine a little light there. But if we think about Raytheon free cash flow at \$3.6 billion last year and UTX defense cash has to be fairly substantial, and again, they're both growing this year, can we think about 2020 defense free cash flow ballpark \$5 billion? Is that a fair place to be before we then start factoring in everything you just talked about?

Anthony F. O'Brien - *Raytheon Technologies Corporation - Executive VP, CFO*

2020 defense cash flow, including Pratt and Collins?

Robert Michael Spingarn - *Crédit Suisse AG, Research Division - Aerospace and Defense Analyst*

Yes.

Anthony F. O'Brien - *Raytheon Technologies Corporation - Executive VP, CFO*

So I think what we've said, Rob, and this hasn't changed too much, right, maybe a little bit, but we had talked about the \$3.5 billion, \$3.6 billion that you mentioned for Raytheon in kind of from 2019 and seeing that play out here this year. I think we'd also said that back in 2019, the Pratt and Collins component was close to \$4 billion last year. Obviously, a big impact to that this year. We are seeing strength this year on the Raytheon side of the house, particularly at RMD with collections.

And again, the question is, will that continue here in the fourth quarter and provide some flexibility? But that's really, give and take, between '20 and '21, obviously, right, if that happens to continue. And then for this year, we had also said Pratt and Collins combined, including the military, was around breakeven, give or take, right? And again, we're seeing things play out generally that way with a little bit of favorability on the legacy Raytheon side going forward. I don't know if I'd get into the \$5 billion. I think that's maybe a bridge too far right now to go that far with overall defense cash flow.

Robert Michael Spingarn - *Crédit Suisse AG, Research Division - Aerospace and Defense Analyst*

Okay. And then just, Greg, a clarification. You mentioned a lot of excess material. I think you were talking about Collins. But just in general, are you seeing more USM activity now than earlier in the pandemic? And what's the trend on that?

Gregory J. Hayes - *Raytheon Technologies Corporation - President, CEO*

I'm sorry, one more time with the -- are you talking about usable material -- serviceable material?

Robert Michael Spingarn - *Crédit Suisse AG, Research Division - Aerospace and Defense Analyst*

Used serviceable material, yes, competing with your spares at both businesses, I suspect.

Gregory J. Hayes - *Raytheon Technologies Corporation - President, CEO*

Yes. So look, it is obviously something that we're -- we keep a handle on. There is a large influx of used material primarily because there have been a slew of retirements. Now if you think about that on the Pratt & Whitney side, that's primarily some of the old Pratt 2000 and PW4000. Those were nearing the end of their useful life. We weren't seeing a huge amount of aftermarket anyways because there was already serviceable material out there. There's a lot more now.

Obviously, the GTF, not so much. We haven't -- we still got our arms around that. And even on the V, I mean you're still -- they're still flying that plane. It's still one of the more efficient. So not a big concern of serviceable material on the Pratt side today, although we'll keep an eye on it as time goes on.

The Collins side, it's obviously a lot more complicated given the diversity of the product line, but there is some serviceable material out there. It is, I think, already having an impact. It's one of the reasons why aftermarket is down the way it is, and that's again why we're cautious about the recovery trend on Collins aftermarket. Again, everybody is doing everything they can from a cash conservation standpoint, and that means even cannibalizing aircraft to keep other aircraft flying.

So I think until we see a return to normalcy and until the airlines can get to a positive cash flow status operationally, I think we're going to continue to see pressure from serviceable material. But again, that's in the numbers already, and it will continue here for some time.

Neil G. Mitchell - Raytheon Technologies Corporation - Corporate VP of Financial Planning & Analysis and IR

Yes, I'll just add one thing to that. Greg mentioned the aftermarket, the way it's performing right now, one of the reasons it is, is because time and material is down. But the visits under contract are there. The customers have paid for those as the engines have flown, and they're coming into the shop with a slightly different work scope. But we do like our position with those engines that are under contract, and that will position us well for continued aftermarket when the recovery occurs.

Operator

And that question comes from Noah Poponak with Goldman Sachs.

Noah Poponak - Goldman Sachs Group, Inc., Research Division - Equity Analyst

In whatever year, global air traffic is back to 2019 levels. Without speculating or specifying that year, just whatever year that is, in that year, do your pre-pandemic merged company cash flow targets stand?

Gregory J. Hayes - Raytheon Technologies Corporation - President, CEO

I wish my crystal ball was that clear. What I will tell you, Noah, is that there will be a divergence in terms of the timing. From when you see 2019 levels of air traffic or passenger traffic recover, there will probably be a 6- to 9-month delay before we see our overall aftermarket business on the commercial side pick back up. At the same time, I think we feel really good about the defense side of the business.

So whatever year that is, will things be back to normal? Who knows? All I would say is we're going to position ourselves so when the recovery does come, we're in a much better position from a cost standpoint. So in fact, cash may actually be good by the time that recovers just because of all the costs that we've taken out of the business. But clearly, the aftermarket will be the bellwether in terms of when we see a full return to normalcy.

Anthony F. O'Brien - Raytheon Technologies Corporation - Executive VP, CFO

We may get there in a different way than we had envisioned when the merger was contemplated, to Greg's point. And if we don't, it would just be that, call it, 6-month delay because of the timing of the aftermarket. But other than that, all else equal, knowing what we know today, I think your statement would directionally be correct.

Noah Poponak - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

Okay. Great. And then just one clarification for the items you gave us for cash flow next year, Toby. If I heard you correctly, you were describing working capital as being approximately flat year-over-year on the balance sheet, so approximately no change on the balance sheet, and therefore, the bridge from EBITDA to free cash flow for the year would be better in 2021 compared to 2020 by whatever this final few billion dollars of negative working capital is going to be in 2020. Is that...

Anthony F. O'Brien - *Raytheon Technologies Corporation - Executive VP, CFO*

Well, I think what we're saying is with the actions that we've put in place this year, where we're 3 quarters of the way through and a big chunk of that, close to \$1 billion, right, was inventory-related reduction, when we exit the year, we feel we're going to be at a point where we can sustain that level, see turns improve in 2021 until we start to see more of a return in the volume as we work up that recovery curve.

Noah Poponak - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

So basically, is it the case that you do not expect any major year-over-year change in working capital on the balance sheet, '21 versus '20?

Anthony F. O'Brien - *Raytheon Technologies Corporation - Executive VP, CFO*

Right now, today, that's our going-in assumption. But I think, as Greg said, we'll give you more of a detailed update in January. We're trying -- what we wanted to try to do here, absent guidance or an outlook for '21, is at least give you some of the major moving pieces on it. So any of these could change a little bit, but just give or take -- yes.

Noah Poponak - *Goldman Sachs Group, Inc., Research Division - Equity Analyst*

And working capital is always a moving target. I'm just trying to figure out, it's a giant number, again, like it was this year or...

Anthony F. O'Brien - *Raytheon Technologies Corporation - Executive VP, CFO*

No, I think give or take, for now, I would say your thought process is okay.

Gregory J. Hayes - *Raytheon Technologies Corporation - President, CEO*

Okay. Thank you all for listening. Just a wrap-up thought. I know everybody's mind is focused on the pandemic and the significant impact it's had on commercial air traffic and on our commercial businesses. Clearly, difficult times. But I would remind everyone, 2/3 of our business is defense-related, and those businesses remain strong with over \$70 billion of backlog. That defense business also gives us the ability to continue to invest through this cycle and to make sure that we have the right technologies for the future. So I know it's tough out there, but I think everybody should keep in mind we're in this for the long term. We've got great liquidity, great cash position and great people and great technology.

So with that, thank you all for listening. Neil and the crew will be around all day today and tomorrow to take any follow-up questions. Have a great day and stay safe. Take care.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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