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Ford Motor Co. (F)

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CORPORATE PARTICIPANTS

Lynn Antipas Tyson
Executive Director, Investor Relations, Ford Motor Co.

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

Robert L. Shanks
Chief Financial Officer & Executive Vice President, Ford Motor Co.

James D. Farley
Executive Vice President & President, Global Markets, Ford Motor Co.

OTHER PARTICIPANTS

Adam Michael Jonas
Analyst, Morgan Stanley & Co. LLC

Ryan Brinkman
Analyst, JPMorgan Securities LLC

David Tamberrino
Analyst, Goldman Sachs & Co. LLC

John Murphy
Analyst, Bank of America Merrill Lynch

Brian A. Johnson
Analyst, Barclays Capital, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day. My name is Imani and I will be your conference operator today. At this time, I would like to welcome everyone to the Ford Motor Company Second Quarter Earnings Conference Call. [Operator Instructions] Thank you. I would now like to turn the call over to Ms. Lynn Antipas Tyson, Executive Director of Investor Relations. Please begin.

Lynn Antipas Tyson
Executive Director, Investor Relations, Ford Motor Co.

Thank you, Imani. Welcome everyone to Ford Motor Company's second quarter 2018 earnings call. Presenting today are Jim Hackett, our President and CEO; Bob Shanks, our Chief Financial Officer; and Jim Farley, Executive Vice President and President, Global Markets. Also joining us are Marcy Klevorn, Executive Vice President and President, Mobility; Joe Hinrichs, Executive Vice President and President, Global Operations; and Brian Schaaf, CFO of Ford Credit.

Jim Hackett will begin with a brief review of our progress relative to the value creation framework we unveiled last quarter. Bob will then review our quarter results in more detail and then Jim Farley will provide a deeper dive into our global markets. After Jim Farley's comments, we'll open the call up for questions and then following Q&A, Jim Hackett will have a few closing remarks.

Our results discussed today include some non-GAAP references. These are reconciled to the most comparable U.S. GAAP measure in the appendix of our earnings deck which can be found along with the rest of our earnings materials at shareholder.ford.com. Today's discussions include forward-looking statements about our expectations for future performance. Actual results may differ from those stated and the most significant factors that could cause actual results to differ are included on slide 43. In addition, unless otherwise noted, all comparisons are year over year. Company EBIT and EPS are on an adjusted basis and product mix is on a volume-weighted basis.

Now, let me to turn the call over to Jim Hackett.

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

Thanks, Lynn, and thanks everyone for joining us today. Before we begin, I'd like to take a moment to honor the contributions of Sergio Marchionne, a charismatic leader who deserves praise not only for his business accomplishments but for his resolute discipline, demanding the most of himself and those around him, courage to speak plainly in the face of adversity and an unwavering commitment to his values. Our thoughts are with his family and colleagues and may Sergio rest in eternal peace.

Now, please turn to slide 2. In April, we shared our framework to improve the competitiveness, profitability and returns of our portfolio and to drive sustainable value creation. This includes four smart choices for growth: A winning portfolio, commitment to new propulsion, investment in autonomous technology and advancement of Ford's role in the mobility experience.

At that time and filtering for value creation, we also put a spotlight on the divergence between the accretive and dilutive parts of our business. We said we're going to feed the high performing parts and deal decisively with areas that destroy value. And we affirmed that where we can raise the returns of underperforming areas via fitness and/or alternative business models, we would, and we would disposition the rest.

Today I want to provide an update on how we're moving swiftly to execute against that framework including the AV and organizational changes we announced yesterday. There's plans for restructuring that I will discuss in a moment as well as an update on our near and longer-term targets. And I'm also going to touch on our underperformance in China and Europe.

So back to the growth strategy. Let me start with our commitment to cultivating a winning portfolio, and if you would turn to slide three. Now this graph, which is based on our 2017 results, and is similar to what we showed you last quarter, shows our profitability by region. It gives you a clear roadmap of where, from a geographic perspective, we have opportunities to redesign our business model. Now this redesign includes the reallocation of capital to opportunities with higher returns, restructuring and strategic partnerships. Now relative to restructuring, and mind you, we see this underneath that redesign, we now believe we have the potential for about $11 billion of EBIT restructuring charges with $7 billion of cash-related impacts over the next three to five years.

It's no surprise that North America, which is solidly in the upper right quadrant on that chart, accounts for all our company EBIT. With returns of about 24%, the region earns well above our cost of capital which is evidence of our earnings power when we focus our portfolio on where we can win. And over time, North America's return profile should improve further driven by fitness and our decision we talked about last call to no longer allocate capital to traditional sedan silhouettes. Now these actions give us confidence in our target to return North America to 10% EBIT margin.

Notwithstanding this quarter, Europe and Asia Pacific have been profitable but with nagging low margins and ROIC below our targeted cost of capital. Now South America, well it's firmly in the lower left quadrant with highly dilutive margin and ROIC. Middle East and Africa is in the same quadrant. However this year, that team has done an excellent job on fitness and the region now has a credible path to growth and improved returns.

Now I'd like nothing better than to give you visibility into the specifics of how we may restructure, but I want you to recognize we're mindful of all of our stakeholders here, the employees, dealers, unions, regulators, government officials and investors. Therefore we only can share information publicly once decisions are made. And we followed a similar approach last quarter when we announced our decision to exit sedan silhouettes in North America, but our commitment is to keep you informed and often.

When you have strong and weak franchises in regions, it's not as simple as just pulling the plug or exiting markets. We know we can capitalize on our strengths – we have a strong brand – bolster underperforming products and regions and then smartly and selectively disposition where we cannot make an appropriate return. To do this well and with grounding in the future, it takes some time, more than the year I've been in this role.

As we mentioned in our earnings release, we have postponed our September Analyst Meeting. Now this was driven by the fact that we're in the midst of our global business redesign efforts. There's important partnership discussions that are taking place and because of the uncertain policy environment that we're all in. We plan to do two things: first we're going to reconvene when we have concrete details to share, but we're going to update you more certainly with touch points such as conferences and one on one meetings and daily interactions. We plan to communicate frequently.

Now let me turn back to the other smart choices for growth that I've been highlighting, so turn to slide four. This is the area where we're starting with new propulsion choices. We continue to stand by our global commitment to the Paris Accord 2 degree stabilization glide path. And we're using this to guide our business. For example, we're on track to add hybrid electrics to our high volume profitable vehicles like the F-150. Our battery electric vehicle rollout starts in 2020 with a performance utility and we'll have 16 BEVs in our portfolio by 2022. Those 16 are all additions to our portfolio.

In the quarter we had announced two new fuel efficient taxis, hybrid and diesel, to give operators more choice and lower total cost of ownership. We also introduced an all new Police Interceptor Utility hybrid. People said it couldn't be done. This is the industry's first pursuit-rated hybrid SUV delivering improved performance at a lower cost.

Now the next area of growth is autonomous technologies. So coincident yesterday we announced the reorganization of our autonomous vehicle efforts into a single entity under the Ford Smart, Ford Mobility umbrella. This new Ford Autonomous Vehicles LLC will be led by CEO Sherif Marakby. Sherif has had a long career at Ford, time at Uber, and it's an important step to provide our customers with trusted mobility services while creating long-term value for our stakeholders. This new structure, which allows for third party investments, brings together the teams who have focused on our AV development for the past 18 months with a singular focus of commercial deployment of our AV business in 2021.

For your information, by 2023, we will have invested $4 billion into the development of our AV business and this includes the $1 billion we announced when we became a majority stakeholder in Argo AI. By creating this AV LLC now, we can leverage the incredible strides our development teams have already made and streamline future decision making and better capitalize on market opportunities.

In the mobility segment of our growth strategy, we expanded the scope of our strategic partnerships with a new memorandum of understanding with Zotye to establish a JV to provide smart customized all-electrical vehicle solutions in China's fastest growing ride hailing market. We also signed a letter of intent with Baidu in China to jointly explore areas of cooperation in connectivity, artificial intelligence and digital marketing. And Ford Commercial Solutions introduced two new connected vehicle products to provide fleet managers and telematics service providers direct access to valuable OEM grade vehicle data. This is the power of the APIs to allow them to better manage their fleets.

Let me go back for a moment to the winning portfolio. Candidly, we're extremely dissatisfied with our performance in Europe and China and we had not planned for these types of results. For each region we've identified root causes. This is why I mentioned with the winning portfolio we see issues there. And we know how to do this, the actions required to get these businesses back on track. In fact today, I've invited Jim Farley to take you through a deeper dive on this before we go into Q&A.

Let me return to the announcements we made yesterday and touch on four key management changes that we announced along with the new AV LLC. As I mentioned, Sherif Marakby is the CEO of that. He will report directly to Marcy Klevorn. And Marcy had a rich history at Ford, building the software stack as our Chief Information Officer. I'm really happy that Marcy will now focus execution with this group.

Joe Hinrichs will now have responsibility for IT and our global order-to-delivery system. In support of fitness initiatives, this realignment will help us accelerate the integration and application of technology across the industrial system to further streamline manufacturing, adopt big data, speed vehicle delivery times, reduce inventories and improve capital efficiency. Joe's had roles not only in setting up new businesses around the world running North America, but also was part and parcel to these important negotiations 10 years ago that helped save the company. He's got a great view of the business end-to-end and is an important assignment.

Under Jim Farley's leadership, we're now embedding a deeper product line focus across the company which will allow global product line teams to put greater emphasis on customer insights and market opportunities, delivering more user driven products and services. This approach builds on the success we've already experienced with our F-Series teams in North America, the Ranger team in Asia Pacific and we've copied it with the commercial vehicle team in Europe. We're also suddenly making a linkage between the market leadership and the product leadership here.

And Hau Thai-Tang, Executive Vice President of Product Development and Purchasing, will now report directly to me. This move ensures that these critical functions have an even stronger voice at our leadership table as we execute on fitness and we create the winning portfolio around the world.

Okay. Turn to slide six for me please. And before I turn it over to Bob, let me say that I am confident in our plans to create a winning portfolio and execute on our other growth drivers including AV. I mean North America and credits, the quarter they just have shouldn't be lost in our news today. They had very solid quarters. And while Europe and China are notably challenged, we're moving swiftly to stem the negative tide in both of those businesses. We've been working on this. We have line of sight to about $11 billion in restructuring with cash related effects of $7 billion over the next three to five years, which we believe will provide substantial benefits from both a growth and a profitability and return perspective.

Now due largely to the performance in Europe and China, today we're lowering our 2018 EPS guidance range to $1.30 to $1.50. I'll say it again, $1.30 to $1.50 despite better than expected performance from Ford Credit and North America. I'm going to get asked this question, so let me say looking further out, we are still targeting the 8% EBIT margin and high teens ROIC by 2020.

So let me at this point turn it over to Bob for more detail.

Robert L. Shanks

Chief Financial Officer & Executive Vice President, Ford Motor Co.

Thanks, Jim. If we could go to slide eight please. Clearly as Jim said, our second quarter was challenging. This was due in part to unexpected events over which we had little control such as the fire at our U.S. supplier Meridian. It also reflects a policy environment that's increasingly uncertain, causing real unfavorable bottom line effects on the business such as higher commodity cost beyond normal cyclical effects as well as tariff-related impacts.

The quarter however also underscores the importance and urgency of the work well underway in Ford to redesign our business. And as we do this how critical it is that we consistently focus our capital on areas where we have confidence of earning an appropriate return. And where we don't we must and are addressing those issues. Thus the $11 billion of EBIT contingencies with $7 billion in cash-related effects that Jim just mentioned.

It's important to highlight that we believe we can fund these cash effects without impinging on our other capital outlays including investments for growth and our regular dividend. You'll note that all of the metrics for the quarter were lower than a year ago. These declines were primarily driven by lower volume of high margin products in our North America business due to production disruptions caused by Meridian, along with performance issues in our China operations.

Now at a high level, company revenue was about $39 billion. Company adjusted EBIT was $1.7 billion with an adjusted margin of 4.3%. Adjusted EPS was $0.27 and this included an effective tax rate of about 21%. And company cash and marketable securities at quarter end were about $25 billion with total liquidity at about $36 billion.

On slide 10, the year over year bridge for company revenue, the $1 billion decline in revenue was more than explained by lower volume, fully explained by North America, which was the Meridian disruption, and Asia Pacific, which was mainly our China consolidated operations. All other factors improved.

Turning to slide 11. The company's adjusted EBIT was down $1.1 billion from a year ago. This was more than explained by Automotive. As shown on slide 12, our automotive operations were profitable, generating an EBIT of $1.2 billion driven by a $1.8 billion EBIT in North America. This was offset in part by a combined EBIT loss of about $600 million in the operations outside North America, with each region in a loss position except ME&A, which delivered a record second quarter profit. As shown below the graph, North America and Asia Pacific accounted for nearly all the Automotive EBIT decline due to the factors I've already mentioned.

The underlying strength of our North American business came through in the quarter. As detailed on slide 15, we earned $1.8 billion with an EBIT margin of 7.4% despite the adverse impact at Meridian. The year over year bridge for North America, which is detailed on slide 16, shows that effectively the entire $579 million decline in EBIT was due to Meridian.

It's worth looking at this bridge more closely to get a better appreciation for North America's profit trajectory supported by strong market factors. If you exclude the impact of Meridian, the favorable effect of the gain from the IPO of Pivotal and the adverse impact of the Takata settlement, North America's EBIT margin jumps from 7.4% to 9.9%, the level of ongoing margin that we're working to deliver.

Now in our earnings deck this quarter, we are providing you with greater transparency into the profitability and returns of each of our business units that Jim touched on, similar to what we did on our first quarter call for the total company. The graphs show the major parts of each business disaggregated by high and low performance. As you can see in slide 17, the majority of North America's business is strong and high performing with an EBIT of $12.5 billion, a margin of 18% and a ROIC of 48%.

We plan to strengthen and expand this part of our North American business and we've already begun to address the low performing parts, demonstrated by our recent announcement to no longer allocate capital to traditional sedan silhouettes. This is just one part of our effort to return North America to margins of at least 10% and to create a more resilient business.

Now moving to South America on slide 19. The EBIT loss in the quarter of $178 million was unchanged from a year ago. While overall industry conditions improved and we held costs essentially flat excluding the inflationary effects, this was completely offset by the significant weakening of local currencies, particularly the Argentine peso and very high levels of inflation, especially in Argentina.

As slide 20 shows, our business in South America lacks a strong competitive position or profit pillars. In fact, we have not earned an appropriate return on investment over the most recent economic cycle that spans from 2004 to the present. For those reasons, we are moving on a significant redesign of our business model focused on where to play and how to win.

Turning to Europe on slide 22. Let me state plainly that we are disappointed with our performance. The loss of $73 million compares to a profit of $122 million last year. The decline in EBIT was driven by higher costs, primarily regulatory related, and unfavorable exchange, mainly sterling. While market factors were slightly positive, we had expected a much stronger boost from the top line both in volume and net pricing.

Turning to slide 23. Europe similar to North America actually has a strong core product portfolio that last year represented more than 200% of the region's EBIT. This quarter consists of commercial vehicles including Ranger, our Kuga small utility and select imports. On the other hand, the low performing part of our portfolio represents a majority of our volume, revenue and capital deployed in the region, consisting principally of cars and multi-activity vehicles such as C-MAX.

Clearly our European business requires a major redesign and refocus particularly given the ongoing effects of Brexit on our most important and profitable market. That work is already underway, focused on addressing the low performing elements and expanding and strengthening the healthy pillars of our portfolio. It's important to recognize that partnerships, which are a part of our fitness toolkit, are already an integral part of our European operations and going forward we expect them to play an even greater role.

Let's turn now to Asia Pacific. Now effective this quarter, we are breaking China results out separately, which encompasses our unconsolidated JVs plus our consolidated operations. This provides investors greater transparency into how we are executing in this critical market and also how our business in Asia Pacific outside of China is performing.

As you can see on slide 26, a summary of Asia Pacific's key metrics, we had a very difficult quarter with major year over year declines across all metrics, almost entirely driven by China. As slide 27 indicates, the year over year decline in Asia Pacific's EBIT totaled $561 million with $506 million of this coming from our China operation and $55 million from the operations outside China. At the total AP level, the year over year decline was due to lower volume and net pricing as well as lower China JV net income.

Slide 28 provides the absolute and year over year details for China, with the rest of the region shown at the bottom. We are very disappointed in our performance in China. We lost $483 million in the quarter, a decline of $506 million from last year. The decline was driven by unfavorable market factors for Ford and Lincoln imports into China and continued negative industry pricing. The lower net pricing also includes adverse stock accrual effects driven by price changes in response to tariff changes.

The decline in the China JVs was driven by unfavorable volume and mix as well as lower net pricing, which was primarily industry related. Since volumes in the JV were down year over year, we also saw a decline in royalties in compensation for engineering expense that Ford incurred in the past.

Given the large increase this year in Ford engineering expense to support a substantial expansion of our product portfolio, including all new BEVs along with a number of imported products to be localized, the gap between Ford incurred engineering expense and present-year royalties we receive from the China JVs is substantial.

As shown below the chart, the operations in Asia Pacific outside China were profitable, earning $89 million, which was down from a profit of $144 million a year ago. The EBIT margin was 4.2%. This decline was driven by unfavorable market factors, mainly in Australia and ASEAN. India continued to improve, although it did incur a modest loss.

As slide 29 shows, in 2017, Asia Pacific had a meaningful, high performing business anchored by Ranger, most utilities, Mondeo and Mustang. Moving forward, we're focused on getting our China business back on track, including localization of most imported products, sustaining the strong performers in the region outside of China, and getting appropriate returns from our business in India. India is another example of where we're leveraging partnerships, specifically Mahindra, to strengthen our competitiveness.

Now turning to slide 30. Our Mobility segment including mobility services as well as autonomous vehicles, we saw EBIT loss of $181 million, which was down $118 million with both the absolute loss and the year over year variance split about equally between mobility services and investments in autonomous vehicles.

Ford Credit had another strong quarter as shown on slide 31, with modest growth in receivables, earning before tax of $645 million, up $26 million with very strong credit and consumer metrics. Auction values in the quarter were up 4% from a year ago, and we now expect full-year average auction values to be up 1% to 2% at constant mix.

Operating cash flow in the quarter detailed on slide 34 was a negative $1.8 billion, which was driven by unfavorable working capital and timing differences. The balance sheet remains strong as does our liquidity.

And finally as shown on Slide 37, the company adjusted EPS bridge, we have updated our full-year guidance from a range of $1.45 to $1.70 to a range of $1.30 to $1.50. Based on the midpoint of each range, the decline of $0.18 or about 11% reflects lower than expected contributions from Asia Pacific and Europe offset in part by stronger performance from North America, despite taking a substantial hit on commodities and Ford Credit as well as a slightly lower adjusted effective tax rate of 13%.

With that, I'd now like to turn it over to Jim Farley, who's going to share insights on our North America, Europe and China businesses. Jim?

James D. Farley

Executive Vice President & President, Global Markets, Ford Motor Co.

Thank you, Bob. Well it's great to see the progress in North America. In fact this morning, J.D. Power has reported the results of the annual APEAL survey and for the first time in history, a domestic product won the top score, the Lincoln Navigator.

Beyond the products, the 10% margin has galvanized our team in North America. Our performance in the quarter reflects the underlying strength of our current portfolio and mix of trucks and the intense focus the team has on fitness. You can feel the momentum.

We have built strong, profitable, competitive moats like our LCV business. F-Series and Transit make up the industry leader in commercial vehicles, thanks not only to the product but our distribution and commercial capabilities. Our F-Series this year is on pace for a record setting year with sales up 5% and equally strong pricing despite an incredibly intense competitive market.

Talking about the revitalization of our utilities, our first big launch, the Expedition/Navigator, well, sales are up 55% and we are having even stronger results on pricing. All of this is before we refreshed 75% of our North America lineup next year, mostly utilities. We know that when we play to our strengths for customers, we drive strong profits and returns. In contrast, the erosion we've seen in both Europe and China is unacceptable, highlighting why we are changing our portfolio in these regions to profitably grow.

Turning to Europe and our deteriorating results. Despite being only 30% of our revenue, our LCV business continues to be the bright spot, with 13% EBIT margins. This reflects our strong core portfolio with Ford as the number one best selling LCV brand, led by Transit and our vans and Ranger which is now the best selling pickup in the region. But despite this strength, one of our underlying issues is that we are behind on the shift to utilities and now our portfolio under index on this highly profitable and growing segment.

The biggest issue we face is the UK. We're the number one brand in the market. Back in 2016 we made $1.2 billion in Europe and most of it was in the UK. Brexit and the continued weak sterling has been a fundamental headwind for our European business. This explains the majority of our deterioration along with the age and mix of our utilities and cost. Taking all of these factors into account, we now expect to deliver a loss this year in Europe. To deliver on our long-term target of 6% EBIT margin, clearly we have to redesign Europe, centering the operations on our profitable LCV business. We are aggressively attacking costs and driving improved capital efficiencies across the business. Importantly, capital allocation plans now align with utility and the LCV business opportunity.

Turning to China. The deterioration of our business in this important global market has been swift. When we completed the deep dive into the root cause, we exposed serious shortfalls in our go-to-market capabilities, including inadequate dealer profitability, excess stock including our high volume C cars. We now maintain we haven't maintained a fresh enough product lineup for this rapidly changing and dynamic China market. These missteps together, with our uncompetitive cost structure has resulted in a significant deterioration in our 2Q results.

We have taken urgent action. We've addressed the dealer profitability, also our stock and production and we've completely reset our merchandising. New products are on their way. 60% of our lineup will be refreshed or new by the end of next year. However until all of our utilities are launched in China, we'll continue to face this mix deficit. We are improving our cost competitiveness with aggressive fitness actions as well as more localized product, as Bob said in China, such as the Explorer. We're close to hiring a new CEO for Ford China and we have already onboarded a number of local Chinese talent in key management positions such as marketing and sales leads for both Ford and Lincoln to drive not only our strategy but they're already reinvigorating our sales.

China is already the world's largest automotive market, growing to twice the size of the U.S. market by 2025. And I can assure you, we understand the importance of getting our China business back on track. This will complement the progress we've already made in the region with ASEAN and Australia thanks to Ranger and India as Bob mentioned with the work we're doing with Mahindra.

Before we open the call to Q&A, I'd like to end on this. Bob mentioned the sizable provision for restructuring contingencies of $11 billion and $7 billion of cash-related effects. With this and other fitness actions, we are determined to reshape our portfolio of products and markets.

Complementing this is our aggressive reallocation of capital to regions but products that people love in the most profitable segments. We're expanding our incredible lineup of Ford commercial vehicles. We're growing the range of white hot utilities, not just Expedition, but in all sizes and price points. And we're completing the build-out of an incredible urban crossover lineup with world class energy efficiency.

Operator, let's go to the Q&A.

QUESTION AND ANSWER SECTION

Operator: Certainly. [Operator Instructions] Okay, your first question comes from the line of Adam Jonas with Morgan Stanley.

Adam Michael Jonas
Analyst, Morgan Stanley & Co. LLC

Q

Thanks everybody. Just got two questions. First one on restructuring. I want to ask the question, what does $12 billion, I'm sorry, what does $11 billion of charges or $7 billion of cash charges buy you in the restructuring world? But am I wasting everyone's time here? Are you going to – is there anything else you can say in terms of geography, function, region? Anything else tonight besides the number?

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

A

Yeah hi, Adam, Jim Hackett.

Adam Michael Jonas
Analyst, Morgan Stanley & Co. LLC

Q

Hi.

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

A

No we're not going beyond that tonight.

Adam Michael Jonas
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Tonight's not the night for that. Okay, all right. The second question, Jim, is to you. I think the postponement of the Capital Markets Day, it's kind of a pretty big deal, Jim. These types of things you're introducing into the strategy like spending $11 billion over three to five years, dealing with key stakeholders, tech partners, revamping China. It requires someone to be in the seat a fair amount of time to see it through. So to be direct with you, Jim, whenever you do reschedule the Capital Markets Day, to be clear with investors, will you be the one delivering the message or will someone else be doing it?

And I mean that with all due respect. You're a very spry 63 and you got great contributions to the culture and to accelerating cultural change. But I think it's important, and I'm kind of reflecting a fair amount of sentiment in the investment community around management continuity as well. So we really would appreciate a comment on that. Thank you.

James P. Hackett A
President, Chief Executive Officer & Director, Ford Motor Co.

Yeah, thank you, Adam. It's a straightforward. I love the job that I have. We're making tremendous progress. I get to look. This is a year ago that we had our first quarterly call and I've looked back and what we said we would do. We've made tremendous progress. We've made a number of decisions. In fact, a few are worth emphasizing.

One is this product portfolio turnaround, all the work. Of course, as you know the industry, Adam, these are decisions that will fuel growth and profits in the future. I'm not blaming anyone in the rearview mirror, but I had nothing to do with the portfolio that we're now kind of laboring under in a couple markets. And we've taken really decisive action to address all of that.

The second thing is, the fitness initiatives which we introduced, kind of an abstract word, everyone wasn't sure what it meant, we now have earmarked over $11 billion of value. We've started to work on our longer-term planning and we're expecting more to come from that. So it's had more traction than I first forecasted.

The third thing is, is this team has really come together. I feel like, in any kind of endeavor I've been in, it takes time for a group of people to come together and work closely. You heard what these management choices. I'm really proud of the group that I have on side-by-side with me. And hell yes, I expect to be in front of everybody declaring where we're going and what we want to get done. So I think there should be zero question about that.

Robert L. Shanks A
Chief Financial Officer & Executive Vice President, Ford Motor Co.

Could I just comment on the question around restructuring?

James P. Hackett A
President, Chief Executive Officer & Director, Ford Motor Co.

Yeah.

Robert L. Shanks A
Chief Financial Officer & Executive Vice President, Ford Motor Co.

Yeah and so, Adam, we can talk more about this later, but I think you're raising a really important point and I just want to make sure that investors and others who are listening understand why we shared what we did today. So first of all, you should expect that we will be using the earnings calls and other interactions that we have with you and investors and buy side, as things take place and as we can share what our thinking is and our plans and actions, we're going to be doing that real-time.

So what I want to leave with you is this. If you go back to the prior quarter and the what I call, the bubble chart which is the high performing, low performing which we provide for the total company. And then you look at what we're providing today, which is like a next step forward. So we're showing you what that looks geographically. We've also shown you within each region where we have high performing and low performing parts of the business.

The way I would encourage you and investors to think about all of that is, those are, if you will, roadmaps, not specific to the degree I understand you would like to see, but they are roadmaps. They are roadmaps in terms of the strong business that fits inside what, in the aggregate as a somewhat mediocre business, because of the low performing elements that we still have. But it's a roadmap in terms of where we're going to allocate more capital to. It's also a roadmap, in general, of where we're going to allocate capital from.

So as you can imagine, that is a complex thing to do in terms of over the whole business. We're going to have to orchestrate this. It will play out over time. There are many constituencies that we're going to have to manage, because while those numbers that we gave you are large and substantial, they could be even larger if we don't manage this in the right way. I mean, we'd like them to be smaller, so we're going to not, if you will, tip our hand before we need to so that we can manage this in the most efficient and effective way that's possible.

Adam Michael Jonas
Analyst, Morgan Stanley & Co. LLC

Q

I appreciate that, Bob and listen, Ford's a 115 year old company. It's not your first rodeo here in terms of restructuring over that 115 years. I just can't really think of an example where, for such an important restructuring and such large numbers, and you're kind of almost teasing the market with these very large numbers. Even not just for investors, but internally for your own people who are going to read the newspaper and say, what's going on. I mean, doesn't – I'm just, I'm concerned that and seeing examples of people that restructured successfully, including one we lost today, laying it all out in a narrative that can be understood, that can be on the back of a card, like from the Mulally days. That had a powerful impact, because I think the risk is that this industry is so dynamic, possibly yeah, very, very dynamic and cyclical that as that narrative plays out, the rules change, your free cash flow moves negative. And then we're dealing with a moving bar and we don't know what to compare it to. Sorry, that's just feedback. I really do hope you can reconsider the communication strategy because it's just not good enough, Bob.

Robert L. Shanks
Chief Financial Officer & Executive Vice President, Ford Motor Co.

A

No, I understand what you're saying, but let me just provide another, yeah, a few other thoughts for you and others to think about. So one reason that we wanted to provide it is because we have been doing a lot of work in terms of how we're going to redesign the business. We clearly have a point of view, maybe not complete yet, because we still have a lot of more work to do, but we have a point of view about what that redesign is going to entail. We're not providing specifics for the reasons I mentioned, but it's clear that that redesign is going to be fundamental and it's going to be deep and it's going to really address these underperforming parts of the business.

Adam Michael Jonas
Analyst, Morgan Stanley & Co. LLC

Q

Okay.

Robert L. Shanks
Chief Financial Officer & Executive Vice President, Ford Motor Co.

A

The other thing I would remind you is we've been to the rodeo. If you go back 10 years, a number of guys that are sitting around the table and gals went through an enormous restructuring with similar types of numbers if not bigger in the restructuring of North America. And I was there on the day that Mark provided the first view of what The Way Forward plan was going to be. It was high level. We talked about numbers of plants that we might close. I actually looked at the details today. It turned out some of those plants were different. Some of the plants that we were going to close we didn't, and some that we ultimately closed, we didn't think we were going to.

And the thing that's interesting about this and this is another thing that's important for investors to understand, because everybody wants to have the answer today. When we announced that in January of 2006, the last two plants, which we didn't identify at that time that closed were in 2011 when we closed Twin Cities which built the Ranger and St. Thomas in Canada where we built the Crown Vic, the Grand Marquis and the Town Car because it was the right time to do that. We were able to run them out, generate the cash flow, and manage that in the appropriate way. That is exactly the same approach that we're going to take now.

Adam Michael Jonas
Analyst, Morgan Stanley & Co. LLC

Q

Thanks, Bob. Thanks, Jim.

Operator: Thank you. Next we have a question from Ryan Brinkman with JPMorgan.

Ryan Brinkman
Analyst, JPMorgan Securities LLC

Q

Hi, good evening. Thanks for taking my questions. I'm going to ask a question on the $11 billion of restructuring charge and $7 billion of cash outlay in another way. So I understand you're working on a variety of possible actions that you're not ready to disclose including because they may not be finalized, you have a variety of stakeholders and it might not be value maximizing to announce these actions sooner rather than later such as plans to exit a country or region et cetera.

But with that said, now that you have disclosed the potential costs of restructuring, can you also disclose the potential benefits? So for example, what is the return on the $11 billion or the $7 billion? What is the payback period on that investment? What is the improvement to margin and free cash flow that that spending could bring about? Are these costs simply necessary to achieve your targeted 8% EBIT margin and high teens ROIC, or does this take you above and beyond the 2020 targets?

Robert L. Shanks
Chief Financial Officer & Executive Vice President, Ford Motor Co.

A

Yeah, so let me respond to that. So the way that I would think about that, Ryan, and obviously we'll provide more as we can as I mentioned earlier in the Q&A with Adam, think about it this way. We're showing you substantial parts of the business where we get extraordinary margins. And we've told you that we're only going to allocate capital to new investment opportunities going forward that generate the appropriate returns on capital.

In the process, we will either move the low performing parts of the business through fitness or other means in the lower left quadrant up or we will dispose of them. So if you think about what that business looks like, it's going to be a business that rocks. It's going to be a business that generates very strong operating margins just as we do in

North America and very, very strong returns on invested capital. It will look different. It will be different but it will be a much stronger business. And that's exactly what's behind the restructuring charges that we've shared with you today as the, if you will, the creation and the design of that new business.

Ryan Brinkman
Analyst, JPMorgan Securities LLC

Q

Okay. And then the last topic area I want to explore is Asia Pacific. So just looking at the China EBIT bridge on slide 28, and you'll have to correct me if I'm wrong here, but I think the way to interpret this chart is that the change in China equity income is reflected in the JVs category. And then the volume/mix and net pricing comes to the left of that relate to I guess consolidated China operations. Is that right? And if so, I had not realized that your consolidated operations there were material enough to result in that type of a swing factor, $141 million from volume/mix, $101 million from net pricing. Maybe Bob can help me understand that.

And then secondly, Jim, I remember meeting with you shortly after 1Q results and you seemed pretty excited about the potential financial contribution of refreshing something like 80% or 90% of your portfolio in China this year. After your sales performance and profitability in China in 2Q, how are you feeling about the ability to benefit from those launches?

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

A

Let's let Jim Farley take that part first because I'm going to have Bob come back to the way the accounting is coming through. Jim?

James D. Farley
Executive Vice President & President, Global Markets, Ford Motor Co.

A

Yeah, thanks for your question. We have 16 launches in China, all of them in the second half, so we are still very optimistic about the impact of those launches. We have addressed the go-to-market capabilities and gaps that we've seen and dealer profitability etcetera. Most of the launches like the new Focus or new Escort are sedan silhouettes and most of the profit uplift for us and others is really around utilities. So as we build out in 2019 and 2020 the whole new lineup of utilities in China, that's when we're going to get the lift. So it's going to be great to see that revenue build in the second half. The profit will come with our utilities.

Robert L. Shanks
Chief Financial Officer & Executive Vice President, Ford Motor Co.

A

So let me answer the first part of the question Ryan. And that question is exactly why, really it's one of the reasons why we wanted to start disclosing China the way that we are, because of the significance of what goes on outside the joint ventures which is all that we disclosed previously. So you're correct in your understanding that the JV is the $192 million decline that you see in the call-out box under the JV column. We've put against that the royalties because they come from the JVs. And you can see that they're giving us less on a year over year basis because of the volume decline.

So when you think about the rest of the business and the consolidated business, think about it in normal situations we would see a good return, a good profit coming from the Ford imports and the major factor there would be the Explorer, which we've already announced we're going to localize. We have losses for Lincoln, no surprise because we've just started over the last several years to establish it. It's off to a good start. We even grew in the first quarter again. And that business model changes when we begin to localize, which starts in 2019. In fact, if anything, the business case is even stronger with the level of tariffs that we have today.

The piece that you don't see and that's changed and that should change in a positive way as we move forward is around what I call net engineering expense. So Ford Motor Company engineers for the joint ventures today and we get compensation for that product when it comes to market and they start building it, let's say, three or four years from now. So there's a lag between the two.

Jim has talked about the fact that we've got a big product onslaught that's underway, including BEVs, a much stronger lineup of SUVs, quite a number of products coming. So let me just give you a couple of things that will dimension this for you. If you go back to the 2015, 2016, 2014, 2015, 2016 period, the balance between the engineering that Ford incurred in the current year and the royalties that we were receiving from the joint ventures was pretty much balanced, 50/50, so there was no net impact, if you will, on the bottom line because the expense was offset by the royalties.

In 2017, as we began this onslaught of engineering, if you will, for this big expansion of the portfolio, it started to tilt out of balance because we started to invest much more heavily in terms of engineering. But that's for products and an expanded portfolio that comes in years ahead. So we started to tilt out of balance in terms of net expense, net engineering expense. That net engineering expense this year, in an absolute sense, is about $600 million.

So we've gone from balance to a negative net engineering expense of $600 million, and that's a $300 million increase on a year over year basis, which is part of the headwinds that we were facing. That's not part of the guidance change because we had expected that, but that is definitely a major, major factor in terms of the absolutes that we're looking at. As we move forward and the engineering becomes more normalized and we start to see the volumes grow coming from the expanded portfolio, our expectation is that we go back to a much more balanced position, which will be part of the improvement that takes place over time in the China consolidated business.

Ryan Brinkman Q
Analyst, JPMorgan Securities LLC

I see. Thanks for the explanation.

Robert L. Shanks A
Chief Financial Officer & Executive Vice President, Ford Motor Co.

Yes.

Operator: Your next question comes from the line of David Tamberrino with Goldman Sachs.

David Tamberrino Q
Analyst, Goldman Sachs & Co. LLC

Great. Talk about North America. How are you thinking about the back half competition from GM and FCA? They both had pickup truck related headwinds due to their changeovers in the first half. And I think both of them today said they're targeting approximately 100,000 increases from 1H to 2H in their wholesales. So how are you thinking about that increased supply coming into the market for pickup trucks? And are you anticipating any pricing pressure or again that incremental competition for Ford North America in the second half of the year?

James P. Hackett A
President, Chief Executive Officer & Director, Ford Motor Co.

Jim?

James D. Farley
Executive Vice President & President, Global Markets, Ford Motor Co.
A

Well, we're really confident about our leadership position in the truck market. Obviously, we have very new product. Super Duty is doing extremely well. We have good stocks, but they're on the low side. We've had great transaction price improvements despite the sell down of multiple brands' trucks. So we continue to expand our sales and unit volume. We have a refreshed product. As you know, we have the diesel F-150 at 30 miles per gallon, which is great for merchandising and for customers. We have the new Raptor coming, which is very popular and a significant part of our mix now and Super Duty just continues to get traction. Customers seem to really appreciate the powertrain improvements of F-150 including the 10 speed transmission and the other changes we made. So we think we're in great shape.

David Tamberrino
Analyst, Goldman Sachs & Co. LLC
Q

Okay. So no anticipated headwinds. Pickup trucks continue to be strong for Ford. All right. My second question just on the Ford Autonomous Vehicle unit that was announced. How is that business currently capitalized in terms of cash that's been allocated to it? How are you thinking about potential third-party investments? How imminent could that be? Have you been approached? Are you approaching anyone, or is that more just setting it up down the road for potential investments?

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.
A

Dave, this is Jim Hackett. Let me confirm that setting this up does a number of things for us. If you look at the slide 38, it's on the right, this is the part you probably wouldn't see if you were peering into Ford where all the capabilities that we've been in the middle of managing, we now tie that together.

And then the monetization on the other side, which is the promise of this whole business, which many of you have written about. This is expanding in terms of interest. Lots of people of course in other parts of our industry have received capital. So we've had people approach us. We're not disclosing any of that tonight, but yeah we've had interest. And I would just suggest to you a couple things. One, there's not going to be 10 winners in this space when we look back. There's going to be a few and we plan on being one of them. And we can look at the computer industry in a similar evolutionary way to see what happened as it took off.

Two, the Argo AI team, we just met with Bryan today, is really making progress. In fact the velocity of the way the vehicle learns, you got to think about the compounding that you know about from miles driven. The velocity of its learning is faster than some of the chip capabilities that we contract for, which said another way is we're already advancing the neural network learning of this system beyond what people thought it might do, which is great because that's what it has to have in order to be safe and deployable.

The third thing is that we've committed in our plan $3 billion of additional dollars. But that's a fair question to ask if there's more. And, Bob, I'm going to let you address that.

Robert L. Shanks
Chief Financial Officer & Executive Vice President, Ford Motor Co.
A

Well, in terms of the funding, we are setting it up obviously as a separate legal entity. We've done the same thing with Ford Smart Mobility, so there's optionality there. And it is to allow for other partners or participants in the future. We will be establishing a balance sheet if you will for them, but for now it will be funded internally. And I wouldn't disclose any details around that.

David Tamberrino
Analyst, Goldman Sachs & Co. LLC

Q

Okay. That's helpful. I'll follow up later with a few more. Thank you.

Operator: Your next question comes from the line of John Murphy with Bank of America Merrill Lynch.

John Murphy
Analyst, Bank of America Merrill Lynch

Q

Good evening, guys. Maybe just to follow up on this large spend of $7 billion in cash, $11 billion in EBIT. Bob, as you think about this as a CFO sort of philosophically, with maybe not even getting into details, I mean is this the kind of thing that you look at as an 18 to 24 month payback on a standard basis, or is this a sort of a much more holistic turn in the company to something that is totally different than what we're looking at right now?

Robert L. Shanks
Chief Financial Officer & Executive Vice President, Ford Motor Co.

A

Well, what I expect it to do is basically to, if you will, we've got anchors. We swim in the water with ankle weights, big ones. And what we want to do is we want to get them off so that the real underlying strength of this company can come through. And I can tell you it's kind of interesting. Again, I went back and looked at – I actually kept all this stuff. I'm not supposed to. I think it's way past the time, but I kept all the files from back in 2005, 2006, and I was looking at the projections that we made of what would come out of what we called The Way Forward plan. I mean, it paled in comparison versus what we actually delivered. So the power of what this company can bring in terms of returns if it just invests in the right things in the right way and just releases the anchor weights that we historically have carried around with us for whatever reasons will be tremendously powerful.

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

A

And that's why I want to sneak in to Adam and Ryan and all of your questions about how long have those weights been on those ankles. And so this is a credit to the team in a very short time. We're making decisions, planning. We're going to do this very thoughtfully, but with dispatch. And so I'm really proud of that and I'm a little mystified why that doesn't come through, because this, in previous calls, this was the question, are you really going to be candid, Jim, and take a deep look at things, and how quickly will you come to conclusions and what actions will you take? I do understand that it's fair that you want to know what kind of returns these bring in, so we plan to update you on that. But I think this hard work has really happened, and so I'm happy where we stand tonight with what we know.

John Murphy
Analyst, Bank of America Merrill Lynch

Q

So it sounds like you've identified sort of the outperforming products and the underperforming products. So if we look at the rough 6.5 million units of global volume that you have on a consolidated basis, I mean, are we looking at a third of that being sort of the high performing, a third being low performing and one-third in the middle being sort of stuff that you can fix and move up? I mean, what are the rough numbers? I mean, are we going to see potentially significantly lower volume in the future? Is the 6.5 million going to be 4 million or 3 million? Is that the kind of stuff that's going on in the thought process?

Robert L. Shanks
Chief Financial Officer & Executive Vice President, Ford Motor Co.

A

Well, we're looking at that. I mean obviously, when you go market-by-market, and we even provided a few specific comments today that would tell you in certain regions that the majority of volume or revenue is actually low performing. We haven't done that across the board. But your supposition, John, is correct in terms of the magnitude of what we're having to address. But what I would also remind you is that there's a capital reallocation to new things.

So while certainly, some things will be left behind and they should be, there will be new things that we'll be investing in that actually are already more friendly to us, we're already strong, and we see ways that we can expand our portfolio in those areas, both if you will, from a horizontal standpoint as well as vertically. And also Jim is working to identify and get ahead of future trends and try to get us in the forefront of providing products to address those consumer needs, so we don't find ourselves in the future in a situation where we're under-indexed, for example, in utilities in many parts of the world where so many customers have moved.

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

A

And I would add to that, Bryan, or John, that the fitness initiatives, which we've talked about, we've identified 19 of these. Those have come in richer than we originally projected. And so I'm going to assert here that as you stare at the volume as you do and you start looking at the profit performance of the business, it's still realizing lots of value that comes from these fitness initiatives.

John Murphy
Analyst, Bank of America Merrill Lynch

Q

Okay. And then, Jim, you've got a great management team underneath you with Joe and Jim and Marcy and a whole bunch of other people. The plans keep shifting and it's kind of difficult to operate in that kind of environment. Is there any risk of retention or any idea to go out with retention packages, because it sounds like this is going to be a pretty big tariff, and you want to make sure. I mean, it's a great team. You want to make sure you keep them together. How do you think about human capital in this equation?

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

A

It is the center of gravity. And so the company, yeah, the company has addressed that and it's an important thing. In fact, it's so important, it's the kind of thing I discuss with the board quarterly just so that everyone's on the same page about how important these people are to us.

John Murphy
Analyst, Bank of America Merrill Lynch

Q

Okay. And then just lastly, Bob, when you look at the outlook for cash flow, it didn't have the term but still positive. Is that still part of it? I mean, you're saying just the operating cash flow lower year over year versus 2017 but the still positive clause was taken out. Is that reading too much into it or?

Robert L. Shanks
Chief Financial Officer & Executive Vice President, Ford Motor Co.

A

No, no, I'm laughing because I looked at the slides this afternoon. I said, oh, I forgot to add that. Yes, positive cash flow but lower than last year. Thank you for asking that.

John Murphy
Analyst, Bank of America Merrill Lynch

Q

Still positive. Okay. Thank you so much.

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

A

Appreciate the question.

Operator: Okay. We will now take our last question from Mr. Brian Johnson with Barclays.

Brian A. Johnson
Analyst, Barclays Capital, Inc.

Q

Yes. Thank you. We had a lot of discussion around strategic repositioning and restructuring, and I guess we're not going to get more answers there. So instead I want to kind of ask a question more about just the week to week operational management in the quarter and how comfortable you are between the two Jims, Joe, Bob, that you're on top of these issues in Europe, China as they develop. I go back to in May, you reaffirmed your guidance despite the Meridian fire, which indicated things were on track in North America, but probably more broadly, there are at least no surprises or at least other offsets and now we have this. So can you give us a sense just, A, of kind of what really changed so rapidly towards the end of May and June? And B, whether you feel, because I know having been a consultant, it's easy to get to spend a lot of time planning with the five years out and forgetting about the five weeks out, how you make sure that part of the business is running well?

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

A

Well, there's a huge commitment to that. I mean, the way the company thinks about this, we think about it in time phases of now, near and far and each one of them gets attention. I think that from a now perspective, we really know our business. We know where profit's coming from, where the challenges come from.

I think when you stare at the China problem, we're taking full responsibility for what we would do differently with that. And it does go back to the things we've been saying, is that there was some what I would call weak signals that became profound about the product acceptance in China, Ford products and the aging. There were some things about the partnerships that need tuned up. We are a new team and we're committed to these folks and our dealers.

So I'm confident. This is why I said this in my comments, that the things, Brian, that you wonder slipped away here, we actually know how to do. We've got really good people and know how to fix this. There is a sense, I just want to show you the humility of this, China is a really competitive market, hypercompetitive, 20 to 30 competitors that we didn't have a decade ago that are indigenous. So, but I love a challenge like this. I think that our ability to understand customers and use and translate that into product is going to be one of the big pillars of our recovery.

As you think about though, the questions all the way through that time phase of just what we work on now, you can't forget the future. And in the middle of this, we've all been dealing in industry and business with trade and shifts in that regard. I'm really confident the team's been great at dealing with that. If you think about North America, we had all the effects, because we have supply at a higher percentage from North American steel than any of our competitors, same with aluminum. And here we are recording kind of margins that we're seeing today.

So I'm really happy with the unexpected events. A fire hits the company, and it's amazing, amazing what the people at Ford did to turn that around. And you see the extent of what it could have done to damage our business, and we think we're going to actually recover by the end of the year there. So this is just an endorsement that these kinds of things aren't hard for us to manage. And I'm confident that I really believe in everybody here and our ability to address all these things.

Brian A. Johnson
Analyst, Barclays Capital, Inc.

Q

And in terms of what led to guidance reaffirm to guidance cut?

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

A

Well, I mean, you've had a long day in that regard, right, in terms of as you stare at the industry. So I think the headwinds relative to some of these unexpected things are why we've got to have confidence that this isn't being upended by trade and tariffs and things like that.

I'll just make a statement that, I've said this before, the trade structures always have existed. And the best times that you can see business perform inside trade is when there's equilibrium. And forget for a moment who's winning and who's losing. Just think about you design your business to the certainty of that. So all of us are learning how to kind of deal with that unexpected nature. And who can speculate how long the uncertainty will stand? But we're ready to deal with it.

I think when you think of Brexit, for example, it's probably lost in our reporting how profitable the UK normally is for us. And I'm reading about other aerospace companies who want to have you still waiting to see the evolution of that trade structure so they can make decisions. What we're telling you today with the forecast of the charges for restructuring, we're going ahead and starting to deal with the effects of all these things in a way that we get more control of our future.

Brian A. Johnson
Analyst, Barclays Capital, Inc.

Q

Just finally, are you through the WLTP changeover or is that going to pressure third quarter schedules as well?

James D. Farley
Executive Vice President & President, Global Markets, Ford Motor Co.

A

That's a great question. We're through all of our past year cars. We have just S-MAX, Galaxy to go. We still have the commercial vehicles to go. It was definitely a lot of extra workload on the team, not only us, but also the homologation teams, but we are through it now. It's not a material impact to us as a company financially. We've probably had 0.1% or 0.2% maybe lost just because the delay in getting homologation done in terms of our sales. But we're on track and steaming along, which is really important for our light commercial lineup.

Brian A. Johnson
Analyst, Barclays Capital, Inc.

Q

Okay. Thanks.

James P. Hackett
President, Chief Executive Officer & Director, Ford Motor Co.

Thank you. Lynn, so I'd like to just make some closing comments. Thank you everyone for joining us again today. We're committed, as you've heard over and over, that we're taking appropriate and decisive action to drive profitable growth, maximize returns of our business over the long term. We're through this process of identifying opportunities by region to redesign our business model. We are actively reallocating capital to areas where we can generate the higher returns including understanding restructuring and strategic partnerships. Remember, we've announced a few of these. There is a sense of urgency in the company. We're committed to this EBIT margin target of 8%, the high teens ROIC in 2020. And we realize that the China and Europe performance need to be clearer to you and to us in terms of a positive future.

So thank you for following Ford and thank you for joining us today.

Operator: This does conclude today's conference call. Thank you for your participation. You may now disconnect.