

Ford Motor Company

Fourth Quarter 2022 Earnings Conference Call

Thursday, February 02, 2023, 5:00 PM Eastern

CORPORATE PARTICIPANTS

Jim Farley - President & *Chief Executive Officer*

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Lynn Antipas Tyson – *Executive Director of Investor Relations*

PRESENTATION

Operator

Good day, ladies and gentlemen. My name is Jason, and I will be your conference operator today. At this time, I would like to welcome you to the Ford Motor Company Fourth Quarter 2022 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question and answer session. To ask a question, you may press "*" then "1" on your touchtone phone, to withdraw from the question queue, please press "*" then "2."

At this time, I would like to turn the call over to Lynn Antipas Tyson, Executive Director of Investor Relations.

Lynn Antipas Tyson

Thank you, Jason, and welcome to Ford Motor Company's fourth quarter 2022 earnings call. With me today are Jim Farley, our President and CEO and John Lawler, our Chief Financial Officer. Also joining us for Q&A is Marion Harris, CEO of Ford Credit.

Today's discussion includes some non-GAAP references. These are reconciled to the most comparable US, GAAP measures in the appendix of our earnings deck. You could find the deck along with the rest of our earnings materials and other important content at, shareholder.ford.com. Today's discussion also includes forward-looking statements about our expectations. Actual results may differ from those stated. The most significant factors that could cause actual results to differ are included on page 25. Unless otherwise noted, all comparisons are year-over-year. Company EBIT, EPS and free cash flow are on an adjusted basis and product mix is volume weighted.

I want to call out a few near-term key IR engagements. On February 15, Jim Farley and John Lawler will participate in a fireside chat in New York with Rod Lash at the Wolf Global Auto, AutoTech and Mobility Conference.

On March 23, at the New York Stock Exchange, we will hold a teach-in about our new Ford+ segment reporting. This event featuring John Lawler and Cathy O'Callaghan, our Controller, will be webcast. And I'm also pleased to share that our next Capital Markets Day will be Monday, May 22, at our headquarters in Dearborn, Michigan. Please save the date. We'll have more information about this over the coming weeks.

Now I'll turn the call over to Jim.

Jim Farley

Thanks, Lynn, and hi, everyone. We appreciate you all joining us. I'll start by addressing the obvious. Our fourth quarter and full year financial performance last year fell short of our potential. And while we generated record cash flow, we left about \$2 billion of profit on the table due to cost and especially continued supply chain issues. These are the simple facts and to say I'm frustrated is an understatement because the year could have been so much more for us at Ford.

Now I know the question you must be asking, "Why Ford, with that incredible product lineup, and all the restructuring overseas, why aren't you delivering higher profits and more competitive margins?" And it's the right question. So let me share my perspective. With the Ford+ plan we are executing a double transformation. While we're making progress, it's hard work.

As with any transformation of this magnitude, certain parts are moving faster than I expected and other parts are taking longer.

Now the first part of our transformation is to completely overhaul our industrial system – product development, manufacturing and supply chain management – to deliver better cost and quality, this is critical because it provides the foundation for everything else we do. It funds our future, which we're aggressively building today.

Building new, incredible growth businesses like Model e and of course, Ford Pro our huge bet on commercial vehicles, which will be high-growth, high margin, not just products, but software and services business.

Now the second transformation, the growth part, is going better than I imagined. At this point in our journey, I did not expect to be number two in EV sales in the US; I didn't know that Lightning would be completely sold out. And I didn't predict that BlueCruise would be the best hands-free autonomy system in the market, or the Ford Pro software sales would be growing off the charts. And that doesn't even touch all the incredible next-generation EVs and software platforms that will soon be entering the market.

Bottom line, in a double transformation, we must significantly improve our cost and our quality, but at the same time, grow to fulfill that huge promise in Ford+. And frankly, the first part of the transformation has not moved fast enough.

Now this is what we should be known for. It's our legacy and will show we can do it again. We have deeply entrenched issues in our industrial system that have proven tough to root out. Candidly, the strength of our products and revenue has masked this dysfunctionality for a long time. It's not an excuse. But it's our reality, and we're dealing with it urgently.

Over the past year, we have made sweeping leadership changes and brought in world-class talent to reenergize and rebuild a leading industrial organization. We've committed company-wide to implement a lean operating system that will scrub billions of dollars of waste out of our company. And we are shining the light on every inch of our legacy business with knowledge that we must do better every day.

This has been humbling for both me and our team. That said, I've never been more convinced about our plan. I cannot wait to get into work every day because I'm so optimistic about our plan and what we are creating here at Ford.

Now I respect our competition, but I would not trade places with anyone. Why? Because we have a real strategy to grow. We have incredible products, both on the road and the ones you haven't seen in the pipeline. And I believe we now have a world-class leadership team, made up of new and existing talent ready to compete and win.

These strengths will shine through. Ultimately, the proof will be in our results. That's exactly how it should be. We appreciate those who placed their faith in Ford, and we are committed to creating value for all of our stakeholders.

So with that, let me quickly cover some areas of focus.

First, we remain committed to disciplined capital allocation. Now, you saw this in the actions we took in Brazil and India and most recently in Argo. And now South America and IMG are healthy and generating sustainable profits. This work is never done and will continue to be the focus for us going forward.

Our balance sheet and liquidity remain strong and our ability to generate free cash flow has improved significantly. And this is allowing us to accelerate our investment in growth, of course, electrification, but also Pro and software, while importantly, also returning capital to our shareholders.

And we now have created three distinct customer-facing business segments; Blue, e, and Pro, which have given us greater clarity and insights into each of these businesses and how we can improve each of them uniquely.

So let me cover a couple of highlights. I'm going to start with Pro, my favorite, the not-so-secret weapon at Ford. Ford Pro embodies all of our growth levers, and it capitalizes on our commercial vehicle sales leadership and scale to build a world-class ecosystem that delivers great value to our customers and profitable growth for us at Ford.

In North America, our vehicle share is almost twice that of our closest competitor. And in Europe, Ford has been the number one commercial vehicle brand for eight years in a row. Let me bring this point home. Here in North America, our home market, Super Duty, our most important Pro vehicle, owns half the mining business, it owns half the emergency response business and half the utility business.

And the requirements for all these customers are complex. They're not going to commoditize and they require a partner who deeply understands these unique businesses and is dedicated to providing a mix of vehicles, but also services that can improve uptime and total cost of ownership. And we know these customers will pay for software that will enhance their productivity.

Now, we're going to future-proof this business by leading the commercial electrification solutions as well, with E-Transit and F-150 Lightning. E-Transit is already America's top-selling electric van with 73% market share. 60% of all of our U.S. fleet managers plan to add electric vehicles to their fleet within the next two years, and that was before the \$7,500 IRA tax credit was announced, which applies irregardless of the location of raw materials of batteries.

This year, Pro really gets going as we introduce the all-new Super Duty pickup in North America, and in Europe, the 1-tonne Transit. Ford Pro's high-margin software business will continue to grow, especially software for fleet management, telematics and charging. Last year, these subscriptions for software grew over 70%, reflecting new software offerings, a better platform for our software and contracts, and growth in fleet charging attach rates.

We're also increasing our sales of parts and services via a network of 1,000 mobile service vehicles on the road in North America and Europe and over 1,400 specialized commercial vehicle dealerships, many of which open 24/7. In fact, last year, mobile service repair orders increased 85% for us in Pro. And this improves the customer experience while importantly increasing the attach rates of our high-margin parts business.

Now moving to Blue, the team is focused and has delivered the freshest and most appealing product lineup in our industry. We know that typically the fresher the ICE portfolio, the greater

the pricing power. So, our decision to move away from sedans and commoditized utilities to vehicles like Bronco Sport and the Big Bronco, the Maverick, the Puma in Europe and hybrid powertrains has really paid off.

Ford gained nearly one point of market share here in the U.S., last year. And we expect 2023 to be another big, strong year of share growth. Ford Blue is a growth business for the foreseeable future with strong profits and robust free cash flow.

And F-Series was America's best-selling truck for the 46th consecutive year, outselling its second-place competitor by more than 140,000 trucks. We're also launching new pickups like the new Ranger here in North America and in South America later this year after having already launched the new Ranger in Asia and Europe last year.

In addition, Blue is going after billions of cost improvements from engineering to manufacturing to our bill of material. And in quality, we have work to do. Ford has been number one in recalls in the U.S. for the last two years. Clearly, that's not acceptable. We've overhauled our entire enterprise quality operating system. And we are already seeing improvements in initial quality for vehicles coming out of our plants here in North America.

And Model e. It's operating with a start-up intensity to build profitable EVs with differentiated, industry-leading portfolios that customers are going to love. In the U.S., our EV sales growth is twice the rate of the EV segment and more than 60% of our Model e customers are new to Ford.

The F-150 Lightning has been America's best-selling electric pickup since it launched. And the Mustang Mach-E remains a huge hit for our customers. We remain on track to reach our annualized EV production capacity of 50,000 units per month or 600,000 units globally by the end of this year.

For reference, in the fourth quarter, our run rate of production was more like 14,000. So 50,000 is a big growth. And we are on plan for that 2 million units of capacity by the end of 2026. Now to deliver this incredible growth, as we speak, through our facilities in North America, we're adding shifts, expanding our facilities, building out the battery capacity and assembly capacity. Construction is in full swing in Tennessee and Kentucky on our BlueOval City and our three BlueOval SK battery plants. And in Europe, we're moving ahead with a new commercial vehicle battery facility in Turkey.

Now critical to our plan is securing the necessary raw materials for these batteries to get to that 2 million unit rate, especially lithium and lithium hydroxide and nickel. We expect to have 100% of raw materials we need for the 2 million unit run rate secured by the end of this year.

Now we are deep in the development of our second-generation EVs, including our next-generation electric full-size pickup, which, by the way, is awesome. These EVs will be fully software-updatable. That means a brand-new electric architecture, and they're going to be radically simplified. Imagine three body styles, each with volume potential of up to 1 million units and just a handful of orderable combinations. That's what we're doing at Ford for the second generation of products. And that means higher customer sat, better quality, lower bill material and lower manufacturing costs.

When we start reporting according to these new segments in the first quarter, you're going to have complete visibility in the Model e's margin trajectory and understand the key levers to achieve our Model e EBIT target of 8%.

We're already making the customer buying experience better with less friction. Now this is only going to accelerate when the new Model e dealer program takes effect in January next year. This program has been adopted by nearly two-thirds of our 3,000 U.S. dealers, and it's based on a radical redesign on our customer experience.

Next January, we'll be selling EVs in high volume with virtually no inventory, a simple e-commerce platform for our customers, non-negotiated price set by the local dealer and remote pickup and delivery for all customer experiences. We're also expanding BlueOval charging network at all of our dealers and we'll have dealer staff trained not only on software but all the EVs.

Now I've said before, software and experiences will be the key differentiator for our industry. I mentioned earlier that BlueCruise, our driver-assist hands-free technology, was just tested by *Consumer Reports* and judged the best hands-free autonomous system on the market. Let that sink in for a while, the best on the market. Now if you have not experienced BlueCruise, I challenge you to go out and do your side-by-side comparison with our two major competitors.

And at the end of last year, our customers using BlueCruise have now traveled 42 million hands-free miles. So we're scaling incredibly rapidly. That's a fourfold increase in the millions of miles driven since the second quarter of last year. And we have incredible software talent, making this system better every day, including those 600 former Argo engineers who are now working full time at Ford on our autonomous systems. Now before I hand it over to John, just a few things.

Ford is a different company today. We're all about building a stronger customer-focused business that generates sustainable profitable growth and returns above the cost of capital. While our 2022 results fell short of my expectations, I've never been more excited about our future because we have the right plan, the right structure to succeed, the best team on the field and real strategic clarity.

This year is about execution. It's time for us to deliver, and we will with relentless attention to our founding principles, thrift and growth, and we are hitting the ground running. John

John Lawler

Thanks, Jim. As Jim pointed out, our performance in 2022 was below our expectations, and our industrial platform is frankly not where we need it to be. The simple way I measure this is by looking at our cost of goods sold as a percent of revenue and then compare it to our competition. We've all done it. We're much higher. And this speaks to the significant operating deficits we have in product development, manufacturing and procurement. And this is no different from the tough capital allocation choices we've made upon our geographic footprint and product portfolio. Choices designed to yield higher quality growth and improved returns. And we are now applying that same level of discipline to our industrial platform with urgency.

Now on the positive side, our product portfolio has never been stronger. Our new vehicles are a hit with our customers. Our iconic vehicles remain market leaders, and we continue to make strategic and capital allocation decisions to drive growth, strengthen our competitive position and produce returns above our cost of capital.

So turning to the year, we generated a record \$9.1 billion in free cash flow, well above our cash conversion target of 50% to 60%. And importantly, most of the free cash flow came from the Automotive business, and this reflects more disciplined capital allocation, including the restructuring of our operations outside of North America, which until recently was a significant source of cash burn.

Our balance sheet remains strong, and we ended the year with \$32 billion of cash and \$48 billion of liquidity. This, coupled with the improvement in free cash flow, provides us with ample flexibility to both fund our growth and return capital to our shareholders. In fact, today, we declared our first quarter regular dividend of \$0.15 per share as well as a supplemental dividend of \$0.65 per share, reflecting our strong free cash flow and the monetization of our Rivian stake, which is now nearly complete.

Going forward, we intend to target distributions of 40% to 50% of free cash flow, consistent with our focus on total shareholder return. Now for the year, we delivered \$10.4 billion in adjusted EBIT with a margin of 6.6%. And as Jim said, by better executing the things we control, we should have generated as much as \$2 billion more in adjusted EBIT. For example, the instability of our supply chain and production plans caused us to not only deliver lower than planned volumes in the fourth quarter but also incur higher costs through premium freight and other supplier charges.

Now let me give you a quick overview of how our '22 segments performed recognizing that beginning with our first quarter 2023 results, we will no longer have the automotive segments with regional breakouts. Now North America delivered \$9.2 billion of EBIT, an improvement of \$1.8 billion, driven by higher net pricing and increased volume, which was partially offset by higher commodities and other inflation-related cost increases. EBIT margin was 8.4%. We continue to maintain a healthy order bank, and the team is busy preparing the launch of the all-new Super Duty and our seventh generation Mustang later this year, and both of those are incredible products.

In South America, we delivered a profit of over \$400 million, and the region is now de-risked and sustainably profitable.

In Europe, we were slightly above breakeven for the year, but as our fourth quarter results showed clearly below our target. Given the changing macroeconomic environment and demand environment in Europe, we will make the changes necessary to deliver a sustainable business that consistently generates returns above our cost of capital. Our core strength in the region continues to be our leading commercial vehicle business.

In China, we posted a loss of about \$600 million, driven by increased investment in EVs. Lincoln continues to be our profit pillar in the region, but clearly, we have more work to do to ensure our business is growing sustainable and delivering appropriate returns.

Our International Markets Group earned more than \$600 million, driven by the launch of the all-new Ranger and our decision to exit India. And similar to South America, the region is now primed for sustainable profitability. And finally, Ford Credit had another solid year, delivering EBT of \$2.7 billion, which was down \$2.1 billion from the prior year, reflecting lower credit loss and lease residual reserve releases, lower financing margin and lower lease return rates.

Now given the continued uncertainties in the macro environment, I want to provide some context to how we're thinking about 2023. For the full year, we expect to earn \$9 billion to \$11 billion in adjusted EBIT, and that assumes a SAAR of 15 million units in the U.S., and 13 million units in Europe. We expect to generate adjusted free cash flow of about \$6 billion and for capital expenditures to be \$8 billion to \$9 billion.

Our adjusted EBIT guidance includes various headwinds and tailwinds that we believe could impact our business in the coming year. For example, headwinds include an expected mild recession in the U.S., and a moderate recession in Europe, higher industry incentives as supply and demand come back into balance, Ford Credit EBT of about \$1.3 billion, and that's about \$1.4 billion lower than in 2022, reflecting lower lease residuals and credit losses and the non-reoccurrence of derivative gains.

We expect a continued strong dollar. We also expect about \$2 billion lower past service pension income. And we're also going to continue investments in growth, including in customer experience, connected services and CAPEX as we build out our growth plan.

Now tailwinds include improvements in supply chain and industry volume, launch of our all-new Super Duty and then, of course, lower cost of goods sold, including efficiencies in materials, commodities, logistics and other parts of our industrial platform.

Now before taking questions, let me briefly touch on our new financial reporting as well as plans for our next Capital Markets Day. On March 23, we'll hold a teach-in at the New York Stock Exchange. And I'm really excited about this opportunity because it will be our chance to take you through how the new Ford+ segments will alter our financial reporting. The changes will include how revenue, cost products and assets are assigned to each segment.

At the teach-in, we'll also share our recast financials for both 2021 and 2022, and we hope many of you join us at the New York Stock Exchange in person. But we will also broadcast a webcast live, and we will post a toolkit and other materials to orient you around all the materials to help you migrate your models.

Now the teach-in will not be a strategic update. That will come at our Capital Markets Day in Dearborn in May, when we'll update you on our Ford+ strategy. We'll do a deep dive into financial targets and KPIs for each of our new segments as well as for software and services. Now with this new level of transparency, which will be tracked and validated in our earnings materials and SEC filings, we think investors will be better equipped to value how each of our customer-focused segments is contributing to Ford's overall growth and return profile.

And as Jim mentioned earlier, 2023 is a pivotal year for Ford. We have the plan, the talent and the product portfolio in place to take the company to an exciting new level, one that is both differentiated from our past performance and our competitors. And going forward, our new segmentation will provide unprecedented levels of transparency and insight into all aspects of our business, making it easier to hold Ford leadership accountable for delivering superior growth and value for all of our stakeholders.

Now that wraps up the prepared remarks, and we'll use the balance of the time to address what's on your mind. So thank you. And operator, please open up the line for questions.

QUESTION AND ANSWER

Operator

We will now begin the question and answer session. To ask a question, you may press "*" then "1" on your touchtone phone. If you are using a speakerphone, please pick up your handset before pressing the keys, to withdraw from the question queue, please "*" then "2." At this time, we will pause momentarily to assemble our roster.

Our first question comes from Adam Jonas from Morgan Stanley. Please go ahead.

Adam Jonas

Hey, John, Jim, everybody, I appreciate the humility and the self-criticism and the spirit of that on the cost and the execution shortfall. It's refreshing to see that. But when you begin the description about it and how frustrated you are, Jim, and how it's not good enough, I was getting all excited to hear some details and there's just not a lot here, okay? I'm just going to say, it's not a lot of details at all about what exactly the problem is and what you're doing about it and how much to get better this year?

You can disagree if you want, that is my impression. I want to know what it is and because \$2 billion on the table, frankly, that's 130 bps of margin. That's going to go to the consumer anyway. So tell us that's just the beginning, and there's way more to go. Do we have to wait until May for that? Or is there anything else you can tell us to help model the company in the year ahead and what you're doing about it? Appreciate it.

Jim Farley

Thanks, Adam. No, there is a lot more to go. And the industrial system at Ford is a huge opportunity for us. And we have spent the last several months really getting deep on where we need to go. So John, maybe you could start by sharing what you feel comfortable with sharing, but note you're going to hear a drumbeat from Ford on this all throughout the year.

John Lawler

Yes. So Adam, I think if you just step back and look at the three elements of the industrial platform, there's opportunities across each. If you look at our product development system and in our engineering, the level of productivity that we have, so think about \$1 of input and what you get out for that \$1 of input is probably about 25% to 30% inefficient. So, we should be either getting more products through the pipeline or our cost should be significantly lower. Now we have to be very smart about how we go about doing that because we've got incredible products in the pipeline, and there's a huge opportunity on that front, but we also have to balance the quality as well. And so, when it comes to our engineering, I think you should think about it that way, and that's what we're going after.

Our supply chain, there are issues across the supply chain. It cost us, as we talked about last year, at least \$1 billion in premiums that we had to pay, increased freight, premiums on chips, premiums on disruption that we caused our suppliers because our schedule stability was probably worst-in-class and fixing that and the root cause will drive incredible opportunities for us. And let's say that for 2023, it should be at least an incremental \$1 billion at least. And then when you look at our manufacturing system and you go through our plants, you look at the level of working capital we have in, you look at our production schedules, you look at the complexity and what it does or time that takes us to build a vehicle.

And you understand just how inefficient that is. And then you bring that back, that complexity back through the supply chain, and you talk about the number of changeovers that our suppliers have to make to produce the complexity that we have and the time that, that adds to production and the time that it adds the cost and the issues that it drives through. So those are just some of the tip of the iceberg or the things we're going after.

And then if you go back and you look at it, as I said in my remarks, just you look at the math and you look at our cost of goods sold relative to our revenue and then compare that to traditional OEMs, let alone the new OEMs, and you see the size of the prize that we're going after. And what's changed, Adam, I think the answer is, is we just have to show you guys. That's where we're at. We have to deliver it. But as Jim said, as we're taking this lean approach and getting into it, there's a very systematic way we're going at it now, and we are very focused. And we know that this is the number one thing that needs to get fixed in the first part of our transformation.

Jim Farley

And Adam, I'd just like to add as the CEO, there's a lot of choices, they're all very consequential when it comes to the approach to do this. The most important thing for me is, is it sustainable? When you look at Ford, we have cut in the past and it grows back or we have cut everywhere and not really focused on the industrial system. So for me, the approach that we're taking that's very different and very difficult is that it has to be daily work, gaps to competition, countermeasures, action plans for those countermeasures, constant evaluation of the effectiveness of those countermeasures, celebration of those KPIs and our status and daily management. It has to be a more a fundamental approach than holding our breath or dealing with the output like people and getting into the real industrial systems efficiency. And that is a cultural change as a leader. It's a behavioral change. It is not just a program.

Adam Jonas

Thanks, Jim, thanks John. I will connect later. Appreciate it.

Jim Farley

Thank you.

Operator

Thank you. Our next question comes from John Murphy from Bank of America. Please go ahead.

John Murphy

Good evening, guys. Just wanted to follow-up on a similar vein, short-term and long-term. Just for short-term, when we think about the '23 outlook and you look at the \$1 billion for decline in Ford Credit and take that as a reasonably given number, something in that direction and then \$2 billion of lower past service pension income, that's a \$3.4 billion headwind.

But at the midpoint of the range, you're talking about EBIT being roughly flat. So that indicates a very significant \$3 billion plus improvement in the core business, which is a lot to believe when you're looking at the headwinds and the issues that you just faced.

I'm just curious if you can comment on that, maybe walk us to how we get comfortable like we'll see a \$3 billion plus improvement in the core business this year? How do you get these supply

chain issues fixed when some of that are a bit outside of your control and what we hear from suppliers is the volatilities and schedules and it's not just specific to Ford, it's still pretty volatile?

John Lawler

Yes. Thanks, John. It's a great question. That's exactly it. The headwinds are \$4.5 billion to \$5 billion, as we pointed out. And we said we expect on the tailwinds, the pricing to be about neutral. On market forces, I think, are going to drive average transaction prices down. We think probably around 5%. And that will come some from the dealer margins, but also from higher incentives.

And then you step back from it, and we do have the all-new Super Duty, and we expect that to be a positive and we also have a very strong order bank on our commercial vehicles. So we're looking at pricing being about flattish, we said volumes, there's a slight opportunity as industry comes along. So the rest of it falls into cost reductions, and that's exactly right. When you look at those cost reductions, you have to see what's happening relative to the material. And in, there's two phases there. There's one, we do expect commodity prices to come off a bit, to improve a bit, but we also have significant opportunities in our material cost, and we have several initiatives going on to identify those efficiencies. We also have quite a bit of cost when you talk about schedule stability. I don't have the exact data from the competition.

But when I look at our schedule stability, there are significant opportunities through changes that we can take to improve that schedule stability, which will flow straight through to lower surcharges from the supply base because they have to deal with that instability and there's cost that drives as well as the significant premiums we paid in freight for expedite, air freight, et cetera, to just try to keep plants going and keep our suppliers' plants going. So, those are two immediate actions that we can take based on the inefficiencies we saw in '22 that cost us the \$2 billion. And then on top of that, we have to build through the core industrial platform just productivity and efficiencies to drive even more improvement. So that's how we're thinking about it, and that's how we're going about it.

John Murphy

Okay. That's actually incredibly helpful. And just on the long-term, you mentioned, Jim, about scrubbing things foundationally and really getting to some costs that are...they're excess, and I appreciate the three areas you've highlighted. But as we look around the world, Europe had fits and starts of making us all excited that it's going to work and then it doesn't from time to time. And China, you've been chasing competition there, and it hasn't really paid out for you. But there are two very important parts of Europe and China that are very strong for you.

Commercial vehicle in Europe is incredibly strong. So could we just strip Europe back to pure commercial vehicle and could China just strip back to pure Lincoln? Two places we know you're making money and cut out the other stuff so that you can actually fund the transition that you're talking about? We all dance around this stuff and you've headed in this direction with the global redesign, but there's real opportunities here to be really profitable.

Jim Farley

Now, you hit on it. And I'm glad we're getting into some of the strategies. I would think of China business similar to what we've done in South America and IMG. Small but profitable, focused. We've been in the past in China small but focused on everything. And Lincoln and our commercial with JMC is very profitable and an important business, but they have to make the EV transition. And I don't think you can be globally successful in the EV business if you don't compete with the Chinese.

They're going to come to Europe, actually, they're already there. They're going to come to the U.S., BYD is a powerhouse. Geely, there's so many others. And so, we believe China is very strategically important for us. But to win there, we have to make those businesses transition profitably to EV, but I would think of it as small and focused, maybe even more than past.

And in Europe, we have a great CV business, and that commercial vehicle business is getting electrified, they're making that transition now. We have a new Ranger, the electric version of one-tonne Transit is coming later this year. So we have a really strong business. And the decision really is how much do we need, how many engineers, how many people do we need in Europe and how big of a profile do we need in passenger cars? That's the decision. We've already electrified Cologne and that's really the decision. It's not the right time to talk about where we're going to go, but we know exactly our strength in Europe, and we know what we need to do. And you won't have to wait long to hear from us on these things.

John Murphy

Okay. I've got more, then I will get back in the queue. Thank you very much, guys. I appreciate it.

Jim Farley

Yes, sure. Thanks John.

Operator

The next question comes from Rod Lache from Wolfe Research. Please go ahead.

Rod Lache

Hi, everybody. I think, John, you said in response to Adam's question that variable costs would come down by at least \$1 billion. But at the same time, you're acknowledging that pricing could easily be more than \$1 billion negative for \$100 billion North American business with 5 points of average transaction price decline. Can you maybe give us a little bit more insight into that? And can you provide a few specific KPIs that would demonstrate progress on structural costs? They were up another \$2 billion in 2022.

John Lawler

Yes. So on the pricing, we do see the broad market coming in, and transaction prices falling about 5% as an exit rate for '23. Some of that's going to come out of the dealer margins, of course. It's not all going to come from us. But we also have upside, Rod, with some of the launch of the new vehicles. We won't see as much of a price compression there. So, we see pricing net-net for us next year being about flattish. So don't think about it as we're working through '23 as being a negative \$1 billion.

And then I would say that when it comes to the cost reductions, I think what we've got to start showing is, one, that we're getting leverage out of the business, if we're growing the business that our cost of goods sold is growing at a much slower pace. And that as we're coming out with new vehicles, our cost per units are coming down, so our margins are improving. When you look at the design of our vehicles and you compare it to competition, I think if you go through those benchmarks and you go through those teardowns, you can see that there's a tremendous amount of opportunity for us to design out complexity.

And you should see that coming through complexity reduction KPIs on our vehicles. I think that will be key. And it not only will be in the order combinations but also in the parts complexity in

the number of parts. And what we'll be doing is as we move forward through this year, especially at Capital Markets Day, we'll be providing more details on those KPIs. But it's the key areas you should be seeing how much productivity we're getting out of a \$1 of engineering, and we should do something around that from a KPI standpoint because these are the areas that we need to improve.

Rod Lache

Okay.

Jim Farley

Rod, some of the things I think about is the number of complexity sequencing centers we have. Our line-side complexity, number of parts sitting on side of the line, our inventory turns inside the plant. And on the supplier side, it's going to be transparency. We had full transparency down to Tier 3 in our supply chain. It's very important to operationalize better quality and cost.

On the engineering side, it's also indirect. It's the ratio of indirect to direct engineering that we're spending, i.e., the productive engineering that's resulting in customer-facing products. And increasingly, I know it's going to sound a little bit weird, but it's the software output. We are spending as a management team more and more time on our software platform, and the cost of creating software and the complexity of software. And that's something that, we have a lot of KPIs around. They're increasing quickly and are increasingly important for us. It may not be significant for structural cost, but we have to be careful to add a lot of complexity in software.

Rod Lache

So just to put a landmark out there, do you think a year from now we will be looking at structural costs that are up or down, obviously, ex-pension because you have this \$3 billion cost reduction plan? And then I have a second question just on Model e.

John Lawler

Rod, I think it's beyond just structural cost. Our biggest cost element is our material cost. We will continue to invest in our growth-related investments, so connected services. The software, as Jim talked about, we're also continuing to invest, as you know, in our build-out of our batteries. So our spending related costs are going to go up. Volume will drive manufacturing cost, which is in our structural cost. So there will be puts and takes on the structural costs. Our biggest opportunity is in our level of material cost that we have. It's the largest cost element on our income statement, and it's where we are most uncompetitive.

Rod Lache

Yes. Okay...

John Lawler

So, we're going after everything, but I...

Rod Lache

Yes. I think I got the answer on that. Maybe just to switch gears on Model e, if I can ask Jim a question, you've got this target of 8%. And that 8% margin target presumably has some assumptions for where costs will go, but also where pricing is going to go. And just considering everyone's aspirations for growth in EVs, do you think you can stand by those pricing assumptions and maybe a different way of asking this is, do you think you can sell a \$40,000 electric crossover with a 20% gross margin?

Jim Farley

That is a very important question. The reality is we are structuring our portfolio to compete in very specific segments. The crossover is turning out to be the Corolla Civic of the EV business. And the last thing we want to do is commoditize our products by dropping the price. Just look what happened to Henry Ford in the 20s, in the early teens. And that's exactly what we're seeing play out here. We didn't have to touch the pricing and offer in Lightning and E-Transit because we picked the right segments. But the real driver of our future profitability on Model e is the second cycle products. We didn't know when we designed these first three products, we didn't know that our wiring harness for Mach-E was 1.6 kilometers longer than it needed to be. We didn't know its 70 pounds heavier and that that's worth \$300 of battery cost. We didn't know that we underinvested in braking technology to save on the battery size.

We didn't know that we needed the world's best aerodynamics to get the size of the battery smaller. So now we have learned a lot and that second cycle of the product is in the factory right now being developed with a lot of new talent. So I'm very optimistic about our 8% because we are not going to be playing in the two-row commodity SUV market because Ford's tried that in the ICE business, didn't really work out for us. We want to play our hand, our strength, in commercial, truck, larger vehicles on the category side. We do not want to have too many top hats because that costs a lot to engineer. We want to have choice for customers, but we want to design the smallest possible battery for competitive size, and we want to invest differently in our ICE business for radical simplification, 30%, 40%, 50% less fasteners, no brackets in the vehicle. I can go on and on.

We'll get into it at Capital Markets Day. I think we should expect all brands to protect growth when it comes to EV. And that we have to expect negative pricing. And that means software and other items like that becoming even more critical. I can't wait to show you our new electric architecture. That's to me, that's the most critical strategic investment the company is making, not our batteries, not the EV platforms, but our new fully updatable electric architecture because what we've learned on Pro is we can make real money on software.

Rod Lache

Okay. Thank you.

Operator

Our next question comes from Ryan Brinkman from JPMorgan. Please go ahead.

Ryan Brinkman

Hi, thanks for taking my question. Maybe to follow-up on that. I heard you say in the prepared remarks that revenue for software services and charging rose at 70% year-over-year in 2022. I remember you discussing a potential \$20 billion market opportunity by 2030 with a lot of excitement on Pro at the last Investor Day target for 33 million connected vehicles in 2028.

But have you dimensioned how large or profitable this business may be currently? Or are you able to share any more interim goals such as what your expectations are for services revenue or services revenue growth in 2023? Or what the next catalyst might be here for this business, such as I don't know, the number of vehicles launching with Blue Oval Intelligence or anything else we should be monitoring?

Jim Farley

Right. Yes, a great question. We're going to see that on Pro first, and this year is a breakout year for Pro because we have brand-new products, both core in Europe and U.S., are

most...the highest volume, highest profit vehicles are all new, so, a very important year for us. I would say we absolutely have a fantastic business plan that's very specific about software and physical services. The biggest opportunity for us in the short-term is the after sales business. Only 10% of our Pro customers do business with us, and we hardly do any financing with them. And so between financing and parts and service, we have enormous upside in the short-term. And those are very profitable parts of our business.

So I would think of it this way, Ryan. It's like software is starting to drive a closed loop where the customer wants to do more physical service with us. We have all those mobile units, more and more dedicated dealers and more of our commercial customers because of the use of the software is coming back and buying parts for us.

And then the next level of performance is really going to be prognostics. When we could put predictive failure in all the vehicles, like you see on John Deere and Caterpillar, and then drive that into our physical repair facilities, we're going to see a much larger retention in parts and service. So I think the basics of the business are, these are profitable vehicles. We've got new ones coming out. We're going to grow that.

We blew through our parts and service profits and revenue for Pro last year. It's almost like we can't even predict, as that software starts to really drive a different behavior for our customers, the growth in parts and service. But that's the monetization in the short-term for these services in the integrated ecosystem. And then long-term, the real game changer, like autonomy in the retail space, is going to be that prognostics.

Ryan Brinkman

Great. Thank you.

Operator

Our next question comes from James Picariello from BNP Paribas. Please go ahead.

James Picariello

Hi, guys. So the third quarter negative pre-announcement had a narrative around it. It was very high mix on wheels inventory that you couldn't ship and the additional \$1 billion of supplier costs. I know Adam hit on this in his question, but this quarter is missing that storyline. I know it was mentioned that you have line of sight to \$2 billion in profit that you left on the table. But what could really turn around almost immediately in this first quarter in '23 here in terms of like what operational mishaps you know will reverse in the coming months and quarter, whatever the time frame might be?

John Lawler

Yes. I think it comes down to the key driver for the miss in the fourth quarter was the volumes. And the volumes was on availability of key commodities, primarily chips and the fact that many of our suppliers had equipment issues as they were ramping. We think we've worked through a lot of those issues on the ramp in our supply chain.

And as far as the rate inflow on the commodities, the chips, it continues to be hand-to-hand combat, but we're putting corrective actions in place. We've got better pipelines from brokers and spot buys, and we're working very closely with our supply chain down to the Tier 2 chip suppliers. So it's execution, it's changes that we're putting in place on the rate and flow, and it's being more efficient in our scheduling and the stability of our production to reduce expedited freight, expedited costs at our supply chain, et cetera. So, part of it's operational, part of it's

what we're doing working with our supply chain partners, and part of it is getting through the hump on ramping up run rates, et cetera, throughout the system.

James Picariello

Okay. Understood. That's helpful. And then in terms of the earnings bridge for this year, with respect to materials and freight, that \$9 billion headwind in '22, I know you mentioned you're baking in commodity prices to come down. But all in, relative to that \$9 billion this past year, what's assumed in the '23 guide here on this line item?

John Lawler

Right. So if you look at that, it's at least \$2.5 billion depending on where we fall within the range of the guidance. So I think that would be a start point, and then we would go from there. And of course, we're going to be working to do better than that. But that's what we see so far.

James Picariello

At least \$2.5 billion positive?

John Lawler

Yes.

James Picariello

Okay, understood. Thank you.

Operator

Our last question comes from Itay Michaeli from Citi. Please go ahead.

Itay Michaeli

Great, thanks. Good evening, everyone. Just two questions from me. First, I was hoping you could maybe talk about the regional outlook in your 2023 guidance. I don't know that the segments are about to change but hoping we touch on the regions. And then second, maybe for Jim. When we're thinking about the software opportunity on your new electrical architecture on the consumer side of the business, where do you see the biggest opportunity there from a revenue perspective? Is it automated driving? Is it connected services? Just curious what is most interesting there?

John Lawler

Yes. So I think what we would have to say is that given that we're moving to our segments for 2023, we're not going to be reporting the regions. And so, we will give more color on 2023 by each of the business in the segments, so, I'm not going to comment on regions anymore going forward, unless there's a specific reason to do that within one of the segments.

Jim Farley

I think on the demand side, we see the US, around the 15 million range, Europe around 13 million. We're going to see more incentives in the U.S., So we can go through the demand side if that's what you're interested in.

Itay Michaeli

Yes, sure. That would be helpful. Yes. Maybe pricing in Europe would be helpful as well.

John Lawler

Yes. I think in Europe, we're going to see continued pressure on the top line. We've got a 13 million unit in the industry. We think we still have such a strong order bank. Not 'think,' but know we have a strong order bank on our commercial vehicles that we don't see as much pressure there. More of the pressure will come on the passenger side. But pricing in Europe, incentives continue to be strong throughout this year. So I don't think you'll see as much price compression in Europe, as you'll see in North America and the U.S.

But I think definitely for Europe, it's the call on the industry and where do we think that will be offset by the strength of the order bank we have on our commercial vehicles. Coming back to the U.S., as we said, a 15 million unit industry, we think prices are going to come and the industry are going to fall, transaction prices will fall about 5%. You think about that as about a combination of incentives and lower dealer margins. We're starting to see dealer margins come down now as our demand from the industry is easing a bit.

And we're starting to see the inflationary costs come through with the pricing. And so we're starting to see those margins come off. And I think through as we go through the year, particularly in the second half, you'll start to see prices come down through higher incentives by the OEMs.

When you look at our International Markets Group, I think it's a little bit different there. Our key product is Ranger, and that's all new, and that's launching, and so there's incredible demand for it. And so we think we have some pricing power there as well. So I think the puts and takes around the region, if you look at it on a macro basis, and I think it will be more insightful as we talk about what's happening in each of the segments and then specifically what's happening in Pro Blue and e in those segments around the world.

Jim Farley

On the software side, we were guessing before, but now we know what the first three shippable large TAM software revenue sources are for our industry. The first is partial autonomy, the second is safety and security and the third is productivity. And the star pupil in there, the early leader's definitely ADAS on pricing revenue growth.

The growth we're seeing, the demand we're seeing for BlueCruise and all ADAS features is really driving a lot of software shipment. We're about to ship our second cycle of BlueCruise already, and we are really starting to see that is clearly what customers want revenue-wise.

And I do believe in this first three, four years of software to the car that ADAS, that Level 2, Level 3 system, is really the most remarkable TAM. However, in the background, for Ford, the productivity software in Pro is really important. It's maybe unique to us, but it is a very important part of our software revenue, which we will lay out in May. You'll see more specifics on it, but it's very profitable. The customers love the data, and they have a higher demand for the data and the software than the retail customer.

I think the slow burn, the one in the background that I'm super excited about is the third leg of the stool of safety and security, not like someone stole your car, but it's video content, a lot of it tied to insurance. So this is going to be a really interesting area. Think of your car as an extension of your ring and all the safety and security you have in your house now, all that technology, the cars give me another node on that. It will go for everything from teenage drivers to all sorts of things and that video capture is going to be the essence.

Another reason why we think our next electrical architecture is so strategically important for the company because we want to embed that hardware and software and adaptability in the electric architecture so we can ship the software, better software than our competition on safety and security, even if it's a little fuzzy on what the features are today.

Itay Michaeli

Perfect. That's all I have. Very, very helpful. Thank you.

John Lawler

Thank you.

CONCLUSION

Operator

This concludes the Ford Motor Company fourth quarter 2022 earnings conference call. Thank you for your participation. You may now disconnect.