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Deere & Co. (DE)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Deere & Company's Second Quarter Earnings Conference Call. Your lines have been placed on listen-only until the question-and-answer session of today's conference.

I would now like to turn the call over to Mr. Brent Norwood, Director of Investor Relations. Thank you. You may begin.

Brent Norwood

Head-Investor Relations, Deere & Co.

Hello. Also on the call today are Ryan Campbell, Chief Financial Officer; Josh Jepsen, Deputy Financial Officer; Kanlaya Barr, Director of Corporate Economics; and Rachel Bach, Manager of Investor Communications. Today, we'll take a closer look at Deere's second quarter earnings, then spend some time talking about our markets and our current outlook for the fiscal year 2022. After that, we'll respond to your questions. Please note that slides are available to complement the call this morning. They can be accessed on our website at johndeere.com/earnings.

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This call includes forward-looking comments concerning the company's plans and projections for the future that are subject to important risks and uncertainties. Additional information concerning factors that could cause actual results to differ materially is contained in the company's most recent Form 8-K and periodic reports filed with the Securities and Exchange Commission.

This call also may include financial measures that are not in conformance with accounting principles generally accepted in the United States of America, GAAP. Additional information concerning these measures, including reconciliations to comparable GAAP measures, is included in the release and posted on our website at johndeere.com/earnings under Quarterly Earnings & Events.

I will now turn the call over to Rachel Bach.

Rachel Bach

Manager-Investor Communications, Deere & Co.

Thanks, Brent, and good morning. John Deere completed the second quarter with sound execution despite being constrained by persistent supply challenges. Financial results for the quarter included a 19.9% margin for the Equipment Operations. Ag fundamentals remain solid with our order books largely full through the balance of the year and demand starting to build for our model year 2023 products. Furthermore, the Construction & Forestry markets also continue to benefit from strong demand and price realization, contributing to the division's solid performance in the quarter.

Slide 3 shows the results for the second quarter. Net sales and revenues were up 11% to $13.37 billion, while net sales for the Equipment Operations were up 9% to $12.034 billion. Net income attributable to Deere & Company was $2.098 billion or $6.81 per diluted share.

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Taking a closer look at our Production & Precision Ag business on slide 4, net sales of $5.117 billion were up 13% compared to the second quarter last year, primarily due to price realization and higher shipment volumes. Price realization in the quarter was positive by about 11 points.

Operating profit was $1.057 billion, resulting in a 21% operating margin for the segment. The year-over-year increase in operating profit was primarily due to price realization and higher shipment volumes, partially offset by higher production costs and higher R&D spend. The production costs were mostly elevated material and freight. Supply challenges also contributed to production inefficiencies, driving higher overheads for the period.

The increased R&D spend reflects our continued focus on developing and integrating technology solutions into our equipment and unlocking value for our customers. Operating profit for the quarter was also negatively impacted by an impairment of $46 million related to the events of Russia and the Ukraine.

Next, Small Ag & Turf on slide 5. Net sales were up 5%, totaling $3.57 billion in the second quarter, as price realization more than offset negative currency translation. Price realization in the quarter was positive by just over 8 points, while currency translation was negative by about 2 points.

For the quarter, operating profit was down year-over-year at $520 million, resulting in a 14.6% operating margin. The decreased profit was primarily due to higher production costs, specifically material, and an unfavorable sales mix. These items were partially offset by price realization.

To share more perspective on the current global ag and turf industry and fundamentals, I'm happy to be joined today by Kanlaya Barr, Director of Corporate Economics. Kanlaya?

Kanlaya Barr

Director-Corporate Economics, Deere & Co.

Thanks, Rachel. Turning to slide 6. I would first like to take a few moments to talk through some points that are influencing the global industry. Global stock for grains and oilseeds have declined over the past three seasons, and we expect to see significant less production and export out of the Black Sea region. And on the demand side, there was an increase of imports into China as China's hog herd recovered. So, both supply and demand factors are leading to higher crop prices, as reflected in the recent WASDE release.

Meanwhile, growers are experiencing input cost inflation and availability concerns, most notably with fertilizer. Some row crop producers are experiencing higher input cost, many purchase input in advance of the recent inflation and are marketing their crops at elevated prices. As a result, growers continue to experience strong profitability and cash flow. While farmers expect another year of high input costs in 2023, global grains and oilseeds prices have risen enough to deliver healthy margins, profit into the next season.

With respect to farm equipment, two consecutive years of industry-wide production constraints have resulted in further aging of the fleet. The higher-than-average fleet age, coupled with low channel inventory, is contributing to pent-up demand and is likely to remain beyond fiscal 2022.

With this backdrop of continued strong ag fundamentals, we expect US and Canada industry sales of large ag equipment to be up approximately 20%. Order books for the remaining of the current fiscal year are mostly full, and we already see signs of strong demand for model year 2023 equipment with some order books opening in June.

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Small ag and turf industry demand continues to be forecasted to be about flat this year. We are seeing moderate increases from our hay and forage segment, while consumer products are lower due to supply constraint and low inventory in the channel. Rising interest rates will likely impact home sales and home improvement spending in North America. Although we expect them to remain elevated, equipment inventories remain well below normal and are unlikely to begin recovering until 2023.

Now, moving on to Europe. The industry is forecasted to be up roughly 5%, as higher commodity prices strengthen business condition in the arable segment. We expect the industry will continue to face supply-based constraints, resulting in demand outstrip production for the year. At this time, our order book extends through the duration of fiscal 2022 and even into early fiscal 2023 for some product lines.

In South America, we expect industry sales of tractors and combines to increase by approximately 10%. Despite the low trend crop yield due to weather, our customers are very profitable this year, benefiting from high commodity prices. Our order books reflect this strong sentiment and are nearly full for most product lines. Industry sales in Asia are forecasted to be down moderately, as India, which is the world's largest tractor market by units, moderates from record volume achieved in 2021.

I will now turn the call back to Rachel.

Rachel Bach

Manager-Investor Communications, Deere & Co.

Thanks, Kanlaya. Moving on to our segment forecast, beginning on slide 7. Production & Precision Ag net sales continue to be forecasted up between 25% and 30% in fiscal year 2022. The forecast assumes about 13 points of positive price realization for the full year, which will allow us to be price/cost positive for the fiscal year.

Additionally, we expect roughly 1 point of currency headwind. For the segment's operating margin, our full year forecast remains between 21% and 22%, reflecting consistently solid financial performance across all geographic regions.

Slide 8 shows our forecast for the Small Ag & Turf segment. We expect net sales in fiscal year 2022 to be up about 15%. This guidance includes over 8 points of positive price realization and 3 points of currency headwind. The segment's operating margin is forecasted to be between 15.5% and 16.5%. Although price/cost remains positive, for the year, supply challenges as well as higher material and freight costs are expected to continue to put pressure on margins.

Changing to Construction & Forestry on slide 9, for the quarter, net sales of $3.347 billion were up 9%, largely due to price realizations and higher shipment volumes. Operating profit increased year-over-year to $814 million, resulting in a 24% operating margin. During the quarter, there was a one-time gain of $326 million investment remeasurement from the Hitachi transaction. Results were also impacted by a $47 million impairment related to the events in Russia and the Ukraine. Excluding those special items, operating margin would have been 16%. Higher production costs and an unfavorable product mix were detrimental to the quarter results. The production costs were mainly a result of higher material and freight.

Now, let's take a look at our 2022 Construction & Forestry industry outlook on slide 10. Industry sales of earth-moving equipment in North America are expected to be up approximately 10%, while the compact construction market is forecasted to be flat to up 5%. End markets for earth-moving and compact equipment are expected to remain strong, as the US housing market is forecasted to remain elevated, oil and gas activities continue to ramp

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up, and strong CapEx programs from the independent rental companies drive re-fleeting efforts. Compact construction equipment inventory levels are extremely low due to supply constraints affecting those product lines.

In forestry, we now expect the industry to be flat to up 5% and global road building markets are also expected to be flat to up 5%. Road building demand in the Americas remains strong, while China and Russia markets are down significantly.

The C&F segment outlook is on slide 11. Deere's Construction & Forestry 2022 net sales continue to be forecasted up between 10% and 15%. Our net sales guidance for the year includes 9 points of positive price realization and 2 points of negative currency impact. The segment's operating margin outlook has been revised to a range of 15.5% to 16.5%. The update reflects the one-time gain from the Deere-Hitachi transaction and the impairment related to the events in Russia and the Ukraine that occurred in the second quarter of 2022. The normal course of business continues to benefit from increases in price and volume.

Shifting over to our Financial Services operations on slide 12. Worldwide Financial Services net income attributable to Deere & Company in the second quarter was $208 million. This is a slight decrease compared to the second quarter last year, primarily due to the higher reserves for credit losses, partially offset by income earned on a higher average portfolio. For fiscal year 2022, we maintain our net income outlook at $870 million, as the segment is expected to continue to benefit from income earned on a higher average portfolio balance.

Slide 13 outlines our guidance for net income, our effective tax rate, and operating cash flow. For fiscal year 2022, we are raising our outlook for net income to be between $7 billion and $7.4 billion, reflecting the one-time items in the second quarter of this year. The full year forecast is inclusive of the impact of higher raw material prices and logistics costs.

At this time, our forecasted price realization is expected to outpace both material and freight costs for the entire year. The first two quarters are expected to be our most difficult material and freight inflationary cost compares, while the third quarter comparison to last year should improve slightly. As we progress into the fourth quarter, we expect those material and freight comparisons to improve even further. We also expect shipments to be more back half-weighted than we've seen historically as we work through a backlog of partially built inventory waiting for supply parts and while seasonal factories will continue to produce without the typical shutdown period.

Moving on to tax, our guidance incorporates an effective tax rate projected to be between 22% and 24%. Lastly, cash flow from the Equipment Operations is now expected to be in the range of $5.6 billion to $6 billion. The decrease in the forecast reflects the increases in working capital required through the year.

At this time, I would like to turn the call over to Ryan Campbell, Chief Financial Officer, for comments. Ryan?

Ryan D. Campbell

Chief Financial Officer & Senior Vice President, Deere & Co.

Before we transition to the Q&A portion, I would like to make a few remarks on our results and the opportunities ahead of us. Reflecting on the second quarter results, as we indicated in our prior earnings call and outlook, the supply chain-related constraints continued through the quarter and will not likely abate during this fiscal year. With respect to our forecast, excluding the special items in the second quarter, our operational guidance remains roughly unchanged. I want to commend our employees, dealers and suppliers for their efforts to support customers and deliver products as quickly as possible in this dynamic environment.

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Given the strong fundamentals in agriculture, coupled with the underlying supply constraints, we do not see the industry being able to meet all of the demand that exists in 2022. While difficult to quantify exactly the impact of this, we expect 2023 to be another strong year of industry demand. Strategically, each day that passes gives us more confidence in our Smart Industrial strategy and our recently announced Leap Ambitions.

While we are hard at work managing our operations in this dynamic environment, we are also executing on our strategy. Our production systems teams continue to identify and execute against opportunities to drive both economic and sustainable value for our customers and their operations. This is even more critical in an environment where inputs are significantly increasing in costs and are hard to come by.

Rachel Bach

Manager-Investor Communications, Deere & Co.

Thanks, Ryan. Now, before we open the line for Q&A, I would like to dive deeper into a few important topics for the quarter. Let's start with our full year revenue guidance. The top line forecast implies a second half shipment schedule that is higher than the first half. Brent, what factors led to this? And how does Deere plan to deliver on a back half-loaded year?

Brent Norwood

Head-Investor Relations, Deere & Co.

Yeah. First, let's spend a few minutes talking about some of the factors in the first half of the year. The first quarter was unusually low due to the work stoppage that we experienced. So, we expected that the delivery schedule would be seasonally different earlier in the year. We also had two large new product programs that were ramping up to full production in the first half, the X9 combine and the 9R tractor, and our production plans always reflected higher volumes of these products later in the year.

Typically, we have some of our seasonal factories that take shutdowns in the second half of the year. However, this year, we'll see some of our PPA, Production & Precision Ag factories producing through much of the third and fourth quarter. Overall, we expect to have more production days in the second half of 2022 than the previous year, and we expect to grow production progressively from the second quarter through the fourth quarter, meaning we expect Q4 to be our highest revenue quarter for the year.

Additionally, supply disruptions led to inefficiencies at factories, resulting in unusually high inventory of partially completed machines. As soon as we get parts, we will be able to complete and ship the product, providing confidence in the second half shipment schedule. Our guidance does contemplate getting enough parts to fulfill the production schedule. As Ryan mentioned, we are collaborating with suppliers and our factories and are working hard to make sure we get there.

Joshua Jepsen

Deputy Financial Officer, Deere & Co.

This is Josh. Maybe one thing to add there. We're seeing some of this play out in the AEM retail data as well where you see some categories down year-to-date, but choppiness in the month-to-month retails. The decrease in certain categories is not reflective of changes in demand, but more the challenges we're seeing in getting products shipped and not just us but across the industry given the current environment in supply.

Rachel Bach

Manager-Investor Communications, Deere & Co.

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Great. Thank you. Next, let's discuss how margins will progress throughout the year, especially in the context of price and material freight costs. Can you talk a little bit more about how we should think about margins in the second half versus the first half? Brent, how do you expect the rest of the year to unfold?

Brent Norwood

Head-Investor Relations, Deere & Co.

So, we experienced the most difficult material and freight compares in the first half of 2022. Lagging contracts on steel means we've seen progressively higher costs since third quarter 2021. Other costs are ramping as well. Commodities such as copper and aluminum, electronics, and even things like labor and energy are increasing. We'll begin to anniversary some of these cost increases in the third and fourth quarter. So, we'll see easier compares relative to the previous year. Freight remains elevated, too.

Recent COVID lockdowns in China have caused delays in shipping globally, compounding some of the previous logistics bottlenecks. With the supply chain backed up, we're utilizing significantly more airfreight solutions, and we expect this to continue throughout the second half of 2022.

In addition to material and freight, overhead has increased. This has come from the choppiness in the supply base and is particularly evident in the number of partially completed machines and our inventory that are missing, parts required to be complete.

So, while the compare gets easier, we probably won't see much moderation in material and freight cost this year. Fortunately, price realization should get progressively better, potentially making the fourth quarter the highest margin period for us, which is a bit atypical. We have managed our order books differently than we have in the past, enabling us to adapt to changes in inflation. So, as noted earlier, we expect our price for the full year will more than offset increases in material and freight.

Rachel Bach

Manager-Investor Communications, Deere & Co.

Thanks, Brent. Let's take a closer look at ag fundamentals. Kanlaya, can you share more insights?

Kanlaya Barr

Director-Corporate Economics, Deere & Co.

Sure. Let's start with the global stock for grain and oilseeds, which we have seen decline over the last three seasons and that's driven by both the supply/demand side. Now, looking at the demand side, we experienced a large increase in Chinese import and that starting in the crop year 2021 as China's hog herd recovered from the African swine fever.

And now on the supply side, the world's experiencing a significant damage to crop two consecutive years, that was in 2021 crop year and also 2022 crop year as well and in multiple locations, in North America, South America, parts of the CIS. So, together, strong demand and declining supply led to the higher price that we're experiencing over the past two years.

Now, expected lower production of crop from the Black Sea region adds to the challenges that the ag sector already faces. The region accounts for almost about a third of global wheat export as well as a notable source of corn exports. USDA forecasts production in export for wheat and corn to be almost 50% lower for 2022/2023 crop year from the Black Sea region. And in fact, the potential export loss could impact two crop years and as a result,

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right now wheat ending stocks among key exporters could fall below 50 million tonnes, which is the lowest level in 15 years.

Now, looking at the fertilizer prices, which have climbed, and some markets are experiencing scarcities of this critical input, persistent fertilizer constraints and high price will lead the supply chain to adjust, but this is likely going to take some time. If you put these factors together, while row crop producers are experiencing high input costs, many have purchased input in advance of recent inflation and were able to market their crops at high price, which helped mitigate the higher input costs. And also a tight global supply will likely remain supportive of prices next year, which is helping to sustain farmer profitability.

Now, given this backdrop of elevated commodity prices, combined with two consecutive years of constrained machinery production, we have older fleet age and low channel inventory. The fundamentals for agriculture machinery remains favorable.

Joshua Jepsen

Deputy Financial Officer, Deere & Co.

Thanks, Kanlaya. And maybe just to punctuate all of that, we're seeing strong demand as we look into model year 2023 orders and even begin to take orders in 1Q 2023 for certain products in different geographies. So, we're expecting continued demand to be a tailwind going into 2023.

Rachel Bach

Manager-Investor Communications, Deere & Co.

As a follow-up to that, our technology helps alleviate some of the pressure that Kanlaya talked about on the input costs by enabling the customer to use less, while still achieving yields.

Joshua Jepsen

Deputy Financial Officer, Deere & Co.

That's right. And traditionally in ag, to boost yields, we've seen an approach that had to be do more with more. Both rising input costs, our customers are looking at how they can do more with less, and they're looking to us and the strategy that we've been talking about over the last few years, using less inputs but not losing out on yields or in some cases using less input and increasing yields.

So, for example, we introduced a product called ExactRate last year, which applies liquid nitrogen at the time of planting. This helps our customers get more precise with fertilizer usage, which has been a unit input experiencing rapid inflation this year. Not only can this reduce the cost, but also improves our customers' nitrogen efficiencies, unlocking significant environmental benefits as well as helping yield by applying nutrients when the seed needs it most. So, not only do we see continued strong demand, but the demand for our precision ag solutions as our customers look for opportunities to do more with less.

Rachel Bach

Manager-Investor Communications, Deere & Co.

Thanks, Josh. And speaking of precision ag and technology, Deere announced a few acquisitions during the quarter. Ryan, can you share more?

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Ryan D. Campbell

Chief Financial Officer & Senior Vice President, Deere & Co.

Sure, Rachel. Consistent with the themes that we previously discussed of digitization, automation, autonomy, life cycle, electrification and sustainability, we've executed during the quarter to expand our access to talent, technology and business opportunities in these areas.

I'd like to highlight one investment, GUSS Automation, which is a pioneer in semi-autonomous spraying for high-value crops. GUSS Automation brings an in-depth knowledge of HVC customers and innovative solutions that deal with some of the most pressing issues facing that segment today. We look forward to working together on further collaboration with the Deere sales channel and in other areas that drive value for HVC customers.

I highlight this investment as it is illustrative of the new smart industrial strategy focused on production systems. Our teams work to deeply understand customer production systems and how to deliver better outcomes both from an economic and sustainability perspective. Then we work to deliver a differentiated solutions. Sometimes we'll design and deliver that solution organically. Other times we'll invest, partner, or acquire unique capabilities to accelerate that delivery. Overall, you'll see us continue to aggressively expand our capabilities to deliver differentiated customer value, and we will dive deeper into this at our Tech Day on May 26.

Brent Norwood

Head-Investor Relations, Deere & Co.

Now, we are ready to begin the Q&A portion of the call. The operator will instruct you on the polling procedure. In consideration of others and our hope to allow more of you to participate in the call, please limit yourself to one question. If you have additional questions, we ask that you rejoin the queue. Caroline?

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Jamie Cook from Credit Suisse. Your line is open.

Jamie Cook

Analyst, Credit Suisse Securities (USA) LLC

Q

Hi. Good morning. I guess, could you just talk to, obviously, the Street views the second quarter as a miss, how the quarter came in relative to your expectations? And then also just on the – can you just quantify the inventory that you have that you're still waiting for parts? I'm just trying to figure out how big of a deal that is and was that the entire [indiscernible] (26:53) cash flow. Thanks.

Brent Norwood

Head-Investor Relations, Deere & Co.

A

Hey, Jamie. Yeah. Thanks for the question. With respect to the second quarter, there's a lot of different variables going on there. Certainly, inflation has been broader based than just steel. We're seeing it impact a lot of other commodities, and I think we see continued pressure on material cost that have kind of led to some of the margin performance in the second quarter. I think in addition to that, just with the delays in delinquencies we're seeing in the supply chain, we're utilizing a lot of additional premium freight right now. So, that's also having an impact on our results for the quarter.

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Really, the biggest challenge, though, as we noted in the second quarter, was the number of partially completed machines that you referenced, Jamie. In many cases, those partially completed machines will drive poor overhead absorption, but they also give us a lot of confidence in the second half production schedule because we do have confidence that we'll be able to complete and ship and ultimately retail those parts in the second half of the year.

To give a little bit of an idea of the size of that, I mean you can certainly look at the change in inventory that we had on the balance sheet sequentially in the second quarter from the first quarter. If you go back in history, typically you don't see an increase in inventory in the second quarter. So, that'll give you a little bit of an idea of the magnitude that we saw of those partially completed machines.

Joshua Jepsen
Deputy Financial Officer, Deere & Co.
A

Yeah, Jamie, it's Josh. Just to pile on what Brent mentioned there, those machines sitting waiting on parts, if you look at the back half of the year increase year-over-year in the second half, it represents close to 25%. So, as Brent mentioned, getting those out gives us a significant jump on the back end-loaded sales.

Jamie Cook
Analyst, Credit Suisse Securities (USA) LLC
Q

Okay. Thank you very much.

Operator: Thank you. Our next question comes from Kristen Owen from Oppenheimer. Your line is open.

Kristen Owen
Analyst, Oppenheimer & Co. Inc.
Q

Hey. Thank you for taking the question. Josh, you talked about some of this in some of the commentary that you made, but obviously a lot of noise in the retail statistics and the industry sentiment indicators that we're seeing coming out. Just given the ongoing production challenge, how do you think investors should interpret some of those readings in the context of some of the demand commentary that you've made?

Brent Norwood
Head-Investor Relations, Deere & Co.
A

Yeah. With respect to retail data, we're certainly not surprised to see it come in a little bit choppy this year as certainly we're dealing with delays and delinquencies in the supply base. But I presume that most of the industry is as well, and given the number of partially completed machines, I think we'll continue to see that data come in waves and be a little bit choppy as we get through the rest of the year.

Certainly, with respect to market share on any given month, it's really a function of who can produce what that month. And so, again, that will be a little bit choppy. Certainly, in the – particularly in the first quarter, we probably outperformed our own expectations there with respect to what we could deliver given the work stoppage. I'd say, other than that, we feel like we've been holding our own in terms of retailing machines.

We do have a couple of standouts though and bright spots. 8Rs, in particular, is a product line that we've had a lot of success outperforming the industry in terms of production. Mannheim tractors is as well. So, if you look at the first half of the year, we've picked up a little bit of market share on the 8Rs and then also in Europe for our high-horsepower tractors and certainly look to holding on to that lead as we produce through the back half of the year.

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Joshua Jepsen
Deputy Financial Officer, Deere & Co.

A

Yeah, Kristen, as it relates to demand piece specifically, we have not seen that shift or change or cool as it pertains to large ag, in particular. Anecdotally, for example, in Brazil, as we opened month to month, we filled a month of production in a day when we opened it. And as we start to get ready for early order programs, we're anticipating strong activity as we're talking to dealers who are already out working with customers. So, we think that demand environment continues and provides a good tailwind for 2023.

Ryan D. Campbell
Chief Financial Officer & Senior Vice President, Deere & Co.

A

Yeah, Kristen, it's Ryan. Maybe just to add, some of the customer sentiment surveys can be driven by just the overall volatility in the environment and the input pressures and concerns that customers may have with respect to that. Ultimately, demand comes from the actual economics which we see continuing to be favorable.

Kristen Owen
Analyst, Oppenheimer & Co. Inc.

Q

Thank you so much.

Operator: Thank you. Our next question comes from Stephen Volkmann from Jefferies. Your line is open.

Stephen Volkmann
Analyst, Jefferies LLC

Q

Hi. Good morning, everybody. So, I kind of want to go back to this first half/second half thing if we could. And it feels like a lot of what you're planning on requires the supply chain to sort of improve going forward and get you those parts you need to get those parked vehicles shipped. So, I'm curious, A, how did that play out in April? Because it feels like it actually maybe deteriorated a little bit, but correct me if I'm wrong. And then secondarily, just how much visibility do you have on that in the second half to give you that confidence in that kind of ramp that we're seeing?

Brent Norwood
Head-Investor Relations, Deere & Co.

A

Yeah. Thanks, Steve, for the question. I think with respect to the supply base, we have seen a supply base that got, I would say, progressively worse over the course of 2021. And then really since the fourth quarter of 2021, we characterized the supply base as just kind of persistent challenges.

We wouldn't say that it's necessarily deteriorated over the course of 2022 or gotten better. It's just been persistently challenging throughout the first half of the year. We would expect to see that continue, that same environment to continue over the second half. So, our guidance does contemplate kind of a similar level of choppiness in the supply base as we progress through the year. We don't necessarily see it moderating or getting better.

I think what's a little bit interesting is the – [ph] some of – sort of (33:33) the root causes have changed quarter from quarter, but the end result has been the same, right? In the first quarter, we were primarily grappling with Omicron and a high degree of absenteeism. In the second quarter, we spent a lot of our time responding to recent global geopolitical events as well as lockdowns in China that are having an indirect impact on us through just the bottleneck of global logistics networks.

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So, when we think about the rest of the year, though, we would expect to see that continue a bit, and our guidance certainly contemplates that. And we think the current conditions do support our second half production schedule, and we do have confidence that we will get the parts that we need to complete those machines that are currently in inventory, ultimately, having those ship in retail mostly in the third quarter, maybe a little bit in the fourth quarter there.

Stephen Volkmann
Analyst, Jefferies LLC

Q

Okay. Thanks.

Operator: Thank you. Our next question or comment comes from Tami Zakaria from JPMorgan. Your line is open.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Hi. Good morning. Thank you so much for taking my question. I think you mentioned you're taking orders for 2023 in Europe and order books are opening next months on North America. So, what's the pricing you expect to realize for these products next year given this year has been – is shaping up to be a really strong year in terms of pricing?

Brent Norwood
Head-Investor Relations, Deere & Co.

A

With respect to order books, maybe before I even get to fiscal year 2023, it's just important to note fiscal year 2022 is largely complete at this point for most of our product lines. We will have our early order programs open up for crop care in early June, which is fairly typical for our planters and sprayers. We would expect combines to begin sometime in the fall period. Again, that's fairly standard for us.

For our rolling order books, we'll see Waterloo open up here in the next couple of weeks. And Mannheim is actually already opened up for fiscal year 2023, and we're about a quarter full for the first year – or for the next fiscal year there. And importantly, we are putting pauses in all of these order programs so that we do maintain a little bit of flexibility in pricing as we have an eye towards how material and freight costs are fluctuating into next year.

With respect to our crop care early order program, where we do have prices set, we are seeing pricing for crop care products in the high-single digits for next year. So, we would expect pricing to be above trend line for those products going into next year.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Got it. Thank you so much. That's super helpful.

Operator: Thank you. Our next question or comment is from John Joyner from BMO. Your line is open.

John Joyner
Analyst, BMO Capital Markets Corp.

Q

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Great. Thank you for taking my question. So, maybe asking Steve's question a slightly different way, when looking at the back half shipments, how do you envision the cadence of the ramp higher? Or maybe where are you run rating today versus the level that you expect to get to in the fourth quarter?

Brent Norwood
Head-Investor Relations, Deere & Co.

A

Yeah. Thanks, John, for the question. With respect to our cadence, we do expect to see a slightly different seasonal pattern than maybe what many investors have come to expect from Deere. Some of this had really been in our plans all along with the work stoppage in the first quarter and the new product programs that we're launching like the X9 combine and the 9R tractor.

So, we'll see production progressively ramp each and every quarter, two, three, and then ultimately leading to the fourth quarter, which should likely be our highest quarter with respect to production. Part of what's boosting that as well again is just the completion of those semi-completed machines that are currently on Deere lots in our inventory. So, that will also help.

But keep in mind too, when doing a comparison of 2021 to the back half of 2022, most of our UAW factories were shut down for the last couple of weeks of October. So, that's going to give us a significant higher number of production days in the fourth quarter of 2022 than what we saw into 2021. So, those are some of the things that are impacting our back half of this year relative to what folks saw in the back half of 2021. Thanks, John.

Operator: Thank you. Our next question comes from Tim Thein from Citigroup. Your line is open.

Timothy W. Thein
Analyst, Citigroup Global Markets, Inc.

Q

Great. Thank you. Good morning. I just want to circle back with a comment on the spring EOP and the pricing that's been communicated to dealers. Josh, historically, well, how good of a reference point – obviously, a lot of different products within PPA, but how good of a just proxy should we think of that to the segment as a whole, i.e., those planters and sprayers relative to large ag as a whole?

Brent Norwood
Head-Investor Relations, Deere & Co.

A

Yeah. With respect to our EOP programs and how that serves as a proxy for other large ag product lines, it's a really important first data point for us. First, from just a demand perspective, typically what we see in the early order program for crop care does have some correlation to what we'll see for combines and tractors as well just from an overall demand perspective.

As it relates to price increases, again, I would say that the pricing that we see for our crop care products, planters and sprayers is generally fairly correlated to the pricing we'd see for large tractors and combines in the North America market. You'll see different price as we look through other regions.

As you think about a market like Brazil, we have maybe the most dynamic pricing capabilities there due to the way that we manage our order fulfillment process. And due to higher inflation there and fluctuating FX, you may see pricing in Brazil different and detached a little bit from what we do in our North American market. But other than that, I would say the read-through from our crop care products to other North American products is generally pretty good.

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Joshua Jepsen
Deputy Financial Officer, Deere & Co.

A

Hey, Tim. This is Josh. One another thing to add too that we'll watch really closely is what are we seeing with technology uptake in that early order program. And particularly when you look at planters and sprayers and given the increases in input costs and what we can deliver from a value point of view, we would say our value proposition on a lot of those things has gotten even better with higher input costs and being able to be more precise and more accurate to deliver better outcomes for our customers. So, as we roll those out here, we'll be watching that closely too because we think there's a tremendous amount of opportunity with those features and tools.

Timothy W. Thein
Analyst, Citigroup Global Markets, Inc.

Q

Thank you.

Operator: Thank you. Our next question comes from Jerry Revich from Goldman Sachs. Your line is open.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Hi. Good morning, everyone. I'm wondering if you could just talk about for the Construction & Forestry business, now that you've completed the excavator technology acquisition, what's the impact on the margin profile of the business. And can you update us on your Smart Industrial strategy for C&F specifically now that you have that entire product suite?

Brent Norwood
Head-Investor Relations, Deere & Co.

A

Yeah. Thanks, Jerry. With respect to our Construction & Forestry division, this was really the first quarter that we are operating post the joint venture that we've historically held with Hitachi. Maybe just a quick update on how that's going so far. We still have a supply agreement with Hitachi, and they're still an incredibly important partner to us as we transition during this time. And so far, that has been a really great partnership, and operations have run very smoothly out of our Kernersville factory in North Carolina. So, things are going really well on that front.

Certainly, longer term, we would see this as margin accretive to us, and the way that we've accounted for that historically has put the excavator product line for us at a lower margin relative to other large earth-moving equipment. And so, we do see an opportunity to improve that certainly. And in the short term, though, it may be hard to ferret out exactly what the impact to margins is given the noise of the gain on the remeasurement. But ex that, I think we'll see a little bit of margin accretion this year. But really it's the out years where I think that will continue to deliver for us.

Joshua Jepsen
Deputy Financial Officer, Deere & Co.

A

Yeah. On the technology side, Jerry, I think, like in ag, this is where technology can play a huge role in driving profitability and sustainability for our customers and importantly safety as well. So, you think about labor challenges, skilled labor on the job site, a tool like SmartGrade effectively automates the job that someone with not a tremendous amount of experience can get in and perform a job as well as an experienced operating, reducing rework – in a time like today when contractors have more jobs than they can do and if I can reduce rework because I'm automating parts of the production system, that allows our customers to get more done.

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So, the smart industrial strategy and leveraging technology into construction, earth-moving, road-building, is a big opportunity. We're at the very early stages of this, but a lot of opportunity to create value for our customers. And we're going to continue to methodically work through that. Bringing the excavator in-house is a key step to unlock more value there.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Thanks.

Operator: Thank you. Our next question or comment comes from David Raso from Evercore ISI. Your line is open.

David Raso
Analyst, Evercore ISI

Q

Hi. Thank you for the question. Can I first get a clarification of something that was said earlier? I think, Josh, you mentioned the machines still waiting on parts, if you look at the back half of the year's year-over-year growth, it represents close to 25%. Do you mean 25% year-over-year growth just from those machines shipping, or do you mean of the needed growth in the back half of the year, roughly a quarter of it, 25% of [ph] it's then (44:59) come from the machines that are waiting for a partial...

Joshua Jepsen
Deputy Financial Officer, Deere & Co.

A

Yeah, the latter. Of the growth that we see in the back half, a quarter of it is effectively represented by those machines waiting on parts.

David Raso
Analyst, Evercore ISI

Q

Okay. That's helpful. So, that's the genesis of my question. It looks like the sequential growth from, say, the second quarter run rate for the rest of the year, I mean, it's principally in Production & Precision Ag. And if you look at what's needed in the second half of the year, you basically need to be about 23% higher 2Q to what you average in 3Q and 4Q? So, maybe it'd be helpful for us, can we just break that down? It sounds like the inventory part could be 10% of it, 10% or 11%, let's call it, using your math of that 23% sequential. Can you help us with the two other key pieces you alluded to? Pricing maybe is adding more dollars sequentially, right, from 2Q to 3Q.

And then also the production day comment, the shutdowns. Can you help us a little bit with what level of production day you'll have second half versus, say, what we ran in 2Q? Because I think getting that 23%, I mean those are the three buckets, right? It's partially built inventory. Hey, we're going to take – not take the shutdowns that we usually do, and then you get a little bit better pricing.

Brent Norwood
Head-Investor Relations, Deere & Co.

A

Yeah, David. Thanks for the question. You're absolutely right. Price is certainly a component of it. You saw us raise our price realization forecast for Production & Precision Ag from 10% to 13%. If you look year-to-date for Production & Precision Ag, I think we've averaged close to 10% in the first half of the year. So, the implication on

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the last two quarters is that we'll get a little bit more than that. And so, that's part of the explanation for the higher revenue year-over-year.

With respect to the shutdown period, it really varies factory by factory. Some factories shut down for a couple of weeks, and others shut down for more or less than that. So, it really is dependent on what factory we're talking about. But net-net, the minimization of factory shutdowns, plus the lack of a work stoppage that we experienced in October of 2021, all contribute to higher production days year-over-year that help us support the build schedule that we have currently in place. Thanks, David.

Operator: Thank you. Our next question or comment comes from Michael Feniger from Bank of America. Your line is open.

Michael Feniger
Analyst, BofA Securities, Inc.

Q

Hey, everyone. Thanks for taking my question. There's a lot of commentary right now in the market with consumers "trading down." Obviously, farmers are facing higher input costs where there was reference to the sentiment indicators for farmers have weakened. I'm curious, from your vantage point, have you seen any evidence of farmers trading down in just certain areas? I recognize that Deere's technology helps improve efficiencies for farmers, but is there any sticker shock being observed there? Are farmers trading down in certain product categories to kind of compensate for the higher input costs? Thank you.

Brent Norwood
Head-Investor Relations, Deere & Co.

A

Hey, Mike. Thanks for the question. With respect to price, so far what we've seen in 2022 is it hasn't had much of an effect on demand. And as we noted, we're already seeing indication of interest for 2023 even though some products may be above trend line price realization already for 2023. Certainly, with the material and freight inflation that we're experiencing on our end is real, and when we price for the following year, we take that into account to make sure that we maintain our price/cost ratios.

If you think about the large ag customer, too, machinery is still a relatively smaller portion of their P&L. The bulk of their variable cost structure really relates to seed, fertilizer, and chemicals. I mean, the inputs is where the bulk of their variable costs have always been, and those variable costs are increasing at a much more significant rate than machinery costs. And in many cases, our machinery is lessening the usage and reliance on some of these inputs. So, the more inflation that we see in chemical and fertilizer costs, in many cases, the more valuable our equipment has become to them.

I would make just kind of one other point on that is we have seen significant appreciation in used pricing as well, which has really been helpful for our customers who are purchasing new equipment. It's had the impact of limiting that trade differential for them, which has helped us price – help us get the price we've been able to get this year. And I think we'll be helpful as we look towards next year as well.

Ryan D. Campbell
Chief Financial Officer & Senior Vice President, Deere & Co.

A

Hey. Mike, it's Ryan. Maybe just quickly, we see our take rates for our tech that allow our customers to manage their P&L better. They continue to be very strong, and we would expect them to get stronger. So, if anything, we see customers trading up, not down.

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Operator: Thank you. Our next question comes from Steven Fisher from UBS. Your line is open.

Steven Fisher
Analyst, UBS Securities LLC

Q

Great. Thanks. Good morning. Brent, you just made a comment about used values, in general. I guess I'm curious what you saw with used values in the quarter. Was there any particular strengthening there? And if so, should that be an incremental benefit to the FinCo? And I guess, related to that, I saw that you raised the provision for credit losses. Was that just for Russia? Or can you talk about why that would be and how that might kind of reconcile or relate to any sort of farmer income and farmer confidence? Thank you.

Brent Norwood
Head-Investor Relations, Deere & Co.

A

Yeah. With respect to used pricing, we've seen it be pretty strong really for the last 12 to 18 months. I wouldn't say we had any change from that pattern in the second quarter. It's been consistently strong and consistently outpacing pricing for new equipment.

As it relates to John Deere Financial, we would say that we've really benefited from a higher average portfolio this year and very favorable credit conditions. You will see our provision for credit loss tick up a little bit in the second quarter, and part of that was due to the events in Russia and Ukraine. And also just a really tough compare to 2Q 2021 where, as the backdrop was improving significantly, I think we had negative provision in the second quarter. So, you're just seeing that normalize out. Our provision is still well below the 15-year average. So, all in all, conditions for John Deere Financial remain very favorable.

And maybe just a quick comment on the lease book as well. We continue to see return rates decline, and really at this point they're almost – for large ag, I would say, almost approaching zero there. And then recovery rates on that which does get returned have been increasing for the last 18 months. So, the quality of the JDF portfolio is really good right now, and we expect to see that continue in the interim. Thanks, Steve.

Steven Fisher
Analyst, UBS Securities LLC

Q

Thank you.

Operator: Thank you. Our next question or comment comes from Larry De Maria from William Blair. Your line is open.

Lawrence De Maria
Analyst, William Blair & Co. LLC

Q

Hey. Thanks. Good morning, everybody. You made a comment earlier in the call that the average age was increasing, which is obviously one of the reasons why we're getting trade-ins because the farmers want to make their fleet younger. Can you talk a little bit maybe more specifically on the average age and also where we are now? And how many years would it take do you think to get back towards some equilibrium kind of number where farmers are comfortable? Thank you.

Brent Norwood
Head-Investor Relations, Deere & Co.

A

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Hey, Larry. As it relates to the fleet age, we have seen it age out really since 2013. I think we've aged out every year since then. And really what's led to the further aging of the fleet these last two years has really been the industry's inability to meet demand in 2021 into 2022. So, overall, it's aged out a little bit even in 2022, right, which means we haven't kind of fully hit volumes to replace the equipment that's coming out of the fleet.

Tractors is where we see the most aging in 2022. Combines we actually did produce just enough to bend the age of the fleet down a little bit. We're still well above average there, but we at least produced enough to begin that process of replacing the combine fleet. Thanks, Larry.

Operator: Thank you. Our next question or comment comes from Chad Dillard from Bernstein. Your line is open.

Chad Dillard
Analyst, Sanford C. Bernstein & Co. LLC

Q

Hi. Good morning, guys. I was hoping you could talk a little more about your industry view on small ag. It looks like you kept volume growth flat, but we've seen in the AEM data sales down kind of like mid- to high-single digits at least on a year-to-date basis. So, can you just talk about what gives you the confidence that we'll be able to kind of see growth in the second half? And then as it pertains to Deere, how are you guys thinking about restocking relative to retail demand?

Brent Norwood
Head-Investor Relations, Deere & Co.

A

Yeah. With respect to our Small Ag & Turf business, we've seen retail data come in really choppy there, and in some cases down. I think there's a number of things that are impacting that in the interim.

First and foremost, part of that is just exceedingly low inventory levels are probably starting to have an impact on retail settlements right now. That's been – particularly as you get into things like utility vehicles, riding lawn equipment, compact utility tractors, those continue to be fairly scarce. So, that is impacting, I think, the number of the retail [ph] settlements (55:45). Also, we are seeing a little bit of an impact from just the late spring that we have here. Typically, early springs drive a lot of sales for those types of equipment, so that's certainly having an impact.

Kind of further compounding the issue, though, is our Small Ag & Turf business has probably been the most impacted by acute shortages, and particularly here referring to riding lawn equipment and utility vehicles where constraints around small engines has been a real factor limiting volume, not just for Deere but for the industry as a whole. And so, as we get through the year, we continue to see that be a governing factor ultimately on where volumes can go for Small Ag & Turf.

Kanlaya, anything you'd add to that?

Kanlaya Barr
Director-Corporate Economics, Deere & Co.

A

Yeah. Just to kind of give some ideas on where the market is right now, when you look at the protein prices with beef, pork, and also poultry all at record high, and also milk demand continues to be very strong as well. So, that's going to help support and help offset the rising feed costs. So, I think the margin in that market is still looking pretty steady.

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Brent Norwood
Head-Investor Relations, Deere & Co.

A

And it looks like we have one last caller.

Operator: Thank you. Our final question comes from Seth Weber from Wells Fargo Securities. Your line is open.

Seth Weber
Analyst, Wells Fargo Securities LLC

Q

Hey, guys. Good morning. Thanks for taking the question. I guess just going back on the supply chain, I assume semiconductors is problematic. Is there anything else you'd call out there? And then just related to the semiconductors, is there – so is the assumption – is the message that the mix is disproportionately being hurt on the precision and the tech side because of the semiconductor issue there, is that really weighing on mix, and that should get better in the back half of the year as well? Is that the right way to think about it?

Brent Norwood
Head-Investor Relations, Deere & Co.

A

Yeah. With respect to the supply chain, we are seeing issues be fairly broad-based. Our supply management team would describe it as whack-a-mole. Certainly, chips are an issue and will probably continue to be an issue as we work through the year. I would say, so far we've managed that and have been able to keep that from having a material impact on mix of any kind.

But as we look to the back half of the year, I would expect us not to single out any particular area of the supply base just due to the broad-based nature of it. I mean, we're seeing challenges with castings and wire harnesses and hydraulics and pumps and tires, and it really just depends on the day in terms of what's causing challenges for us. Fortunately, our supply management team has really done an excellent job of working through each of these as they come up, and we've been able to solve them without any material work stoppages or any particular mix issues to call out. Thanks, Seth.

Seth Weber
Analyst, Wells Fargo Securities LLC

Q

Okay. Thanks. Thanks, Brent.

Brent Norwood
Head-Investor Relations, Deere & Co.

I believe that is our last caller. Thanks all. Appreciate it.

Operator: Thank you. That concludes today's conference call. Thank you for your participation. You may disconnect at this time.

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