

Ford Motor Company

Second Quarter 2024 Earnings Conference
Call

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CORPORATE PARTICIPANTS

Jim Farley - *President, Chief Executive Officer*

John Lawler - *Vice Chair, Chief Financial Officer*

Cathy O'Callaghan - *Chief Executive Officer, Ford Credit*

Lynn Antipas Tyson - *Executive Director of Investor Relations*



PRESENTATION

Operator

Good day, everyone. My name is Gary, and I'll be your conference operator today. At this time, I would like to welcome you to the Ford Motor Company Second Quarter 2024 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. If you would like to ask a question during this time, you may press "*" then "1" on your telephone keypad. To withdraw your question, please press "*" then "2." Please note, this event is being recorded.

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, Gary. Welcome to Ford Motor Company's second quarter 2024 earnings call. With me today are Jim Farley, President and CEO, and John Lawler, Vice Chair and Chief Financial Officer. Also joining us for Q&A is Cathy O'Callaghan, CEO of Ford Credit.

Today's discussion includes some non-GAAP references. These are reconciled to the most comparable U.S. GAAP measures in the appendix of our earnings deck, and you can find the deck along with the rest of our earnings materials and other important content at shareholder.ford.com. Our 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 20. Unless otherwise noted, all comparisons are year-over-year. Company EBIT, EPS, and free cash flow on an adjusted basis.

Now, I'll turn the call over to Jim.

Jim Farley

Thanks, Lynn. And thanks for joining us. First, I wanted to thank our global team. Remaking Ford into a high-margin, high-growth, more capital-efficient and a more durable business is really hard work. It requires focus, collaboration and excellence. And I also want to thank our investors. We're committed to creating value consistently over the long-term, and we appreciate your support and input.

Execution against our Ford+ plan allows us to break free from the low-margin, capital-intensive and cyclical attributes that have constrained auto...legacy auto valuations for a long time. And this process does not happen in a straight line. We are absolutely a different company than we were three years ago, and our pace of change is intensifying. The creation of Ford Pro, Blue, and Model e have been a huge catalyst for transparency, accountability and more rigorous capital allocation.

Our Ford Pro business is amazing. It's a high-margin business tracking towards \$70 billion in revenue this year with further opportunities for profitable growth outside of vehicle sales, parts and service and software. And a good example of that is a recent decision by our team to add 100,000 units of capacity of Super Duty in Canada. It not only serves our customers, but it's capital-efficient and has very high returns for many years to come.



Jim Farley (cont'd)

As you know, we flipped our international operations many years ago from deep losses to now profits and positive cash flow, with more opportunities ahead, and that includes China. We also took our product portfolio from too many generic vehicles and infused it with passion and purpose. We built out our iconic F-Series and Transit lines, as well as passion vehicles like Mustang and the new Bronco lineup, and sub-brands like Raptor and Tremor and Dark Horse.

Few OEMs can offer a customer choice like Ford at our scale. Ford is number one in our home market for internal combustion. We're number two in EVs and have been for 2.5 years. And we are the number three hybrid brand in the U.S. But what's less visible, but incredibly important for investors, is the foundational work underway in the company to move to software-defined vehicles and breakthrough digital experiences. And I'll talk about that later, but this will have significant operating leverage.

Ford+ is on track. Today we reaffirmed our adjusted EBIT guidance for the whole year and raised our outlook for adjusted free cash flow. I'm going to comment on our EV landscape and strategy, software technology and services that are growing importance at Ford, our Ford Pro business and quality.

On electrification, we've been very vocal about why electric vehicles are so important and a great choice for customers and businesses. Customers' usage data and cost of ownership data would indicate about 50% of customers who buy automobiles would be better served on buying an electric vehicle.

Now there's lots of misconceptions around EVs on the separate areas of costs like resale value and insurance, course range and charging and battery life, and OEMs like Ford must do a much better job in educating our customers about the advantages that EV offers in terms of cost of ownership. As you know, we are the number two EV brand in the U.S. for over 2.5 years. That's a long time, and we've learned a lot and now we have used those learning's to sharpen our strategy. What we learned is that it's incredibly important to be transparent about Model e losses.

Inside the company as well forces this forced accountability, and the result is our team is getting much more scrappy and resourceful in terms of turning the business around. We are now more disciplined, and have to be, for capital and expense. And this means we will not launch vehicles at a loss that are not good for our business knowing what we know now about the reality of the market equation. And we clearly see China and Tesla as the cost benchmark.

We also see excess capacity that will lead to more pricing pressures, which is in our business plan, more consolidation and many, many more partnerships. We see less vertical integration in some areas to relieve capital, and we see a lot of tough choices on footprint. Early majority customers are really different than their early adopters, particularly in retail. And we see a lot more openness to hybrids and extended-range electric vehicles we call EREVs.

We also see a divergence on electrification adoption between commercial and retail. Commercial customers focus on total cost of ownership. They use the vehicles much more intensely and they do not overbuy batteries that retail customers do. They're also investing in our Pro charging depots and our integrated software because they want to be smart about the cost of charging



Jim Farley (cont'd)

their vehicles. And, I'm happy to say that our EV Pro contribution margin for our EV vans is now already positive.

We also have learned a lot about the size of the vehicle. We believe smaller, more affordable vehicles are the way to go for EV in volume. Why? Because the math is completely different than ICE. In ICE, the business we've been in for 120 years, the bigger the vehicle, the higher the margin. But it's exactly the opposite for EVs; the larger the vehicle, the bigger the battery, the more pressure on margin because customers will not pay a premium for those larger batteries.

And lastly, compliance. There is a lot of pressure on compliance. And the lower demand for EVs, especially the pricing, means that CO₂ credits are now likely going to be needed for fleet flexibility and optionality and will be a critical strategy choice for any company. What are the success criteria's for EVs in the future?

Well, the first one is to have the right mix of fully and partially electric solutions. This is imperative. You have to have a compelling product roadmap and you have to have very flexible manufacturing. A good example is our hybrid business. The global hybrid portfolio at Ford is on track to grow 40% this year across nine nameplates. And we really bet on hybrid trucks.

In the first half of the year, our hybrid pickups, Maverick and F-150, grew more than three times the rate of the overall hybrid segment. Our F-150 hybrid with Pro Power onboard is a game-changer for our customers. Commercial customers have power on the run like job sites, and our retail customers have emergency power backup. And boy! Have we seen that in Texas and all the other extreme weather events, how important that is for our customers.

The second success factor is matching the cost of the Chinese OEMs and Tesla, especially on affordable EVs. Now when people hear about affordability and they think about small and unaffordable, I'd like to address that now. We are designing a super-efficient platform, leveraging innovation across our product development, supply chain and manufacturing teams.

With no engine or drive team, a smaller vehicle could have a much roomier package, actually the interior package of a class above, with a small silhouette. That's a big advantage for customers versus ICE. And we're focusing on very differentiated vehicles, priced under \$40,000 or even \$30,000. And we're going to focus on two segments: work and adventure.

And why does this matter? Well, the use case for smaller vehicles, affordable vehicles, means shorter trips, more urban locations. It fits the duty cycle of an EV. And affordability, well, smaller batteries have an outsized impact on the cost and margin of the vehicle. And the consumer tax credit in the U.S. has become a much larger part of the sticker price of the vehicle and that is supercharging the lower cost of ownership that EVs have already without it. And finally, we have the ability to leverage this platform across many top hats, which will drive scale and large installed base for our growing software business.

And the last success criteria, is to be really careful about your larger EVs. For us, they'll be part of the picture, but success requires even more breakthrough on cost efficiency, much smarter choices on segments, in our case, work and commercial, a lot of partnerships and a lot of technology pathways.



Jim Farley (cont'd)

Overall, the EV journey has been humbling, but it has forced us to get even more fit as a company, including applying it to our ICE business, and that will pay off long run...in the long run. I am so happy we scaled 2.5 years ago, and we have the option to incorporate those learning's into our next generation of EVs launching in the coming years.

I want to double-click on the software technology and services business. Ford, alongside Rivian and Tesla, are really the only non-Chinese OEMs controlling software across all the vehicle domain. Most companies are doing OTAs on vehicle entertainment and Ford now has multi-year experience on updating powertrains, braking, the fundamental performance of the vehicle conductivity. And the breadth of our portfolio, including F-150 and our Pro business, the customer use case is clearly much more complicated than Rivian and Tesla.

Our vehicles are increasingly general-purpose computers capable of delivering the type of application environment, AI for our customers and user experiences that we expect from all of our digital devices. And this allows us to create powerful, connected, ever-improving customized experiences, which I'll talk about.

Many of you may be surprised that Ford leads on OTAs. According to the 2024 OEM OTA capability rankings in North America, we are the leader based on quality of our updates. This is not how many updates we do, although we do a lot, it's about the ability to improve the fundamental performance and capability of the entire vehicle and all the modules in the vehicle, and there's no better evidence than Mach-E.

Longer range, better efficiency on the battery, faster zero to 60 times, better BlueCruise performance, we've done it all with Mach-E for many years now. Our vision is not just a powerful computer on wheels. It's actually a robot. We will link with these digital experiences. Things that only a vehicle can really do, like safety and security, and the other innovative use cases we shared with you at Capital Markets Day. These experiences that will drive higher profitability, accretive revenue and are the reasons for customers to actually stay with Ford and Lincoln, lower marketing costs, are now becoming clear to us.

One example on the retail side on the technology is our first implementation of the Phoenix system, we called the Lincoln Digital experience, with our new panorama display in our new Nautilus. This experience is really a differentiator in the luxury space with Google Maps and Google Assistance and enhanced car-play. Our sales have surged for Nautilus 48%. We now have much younger customers.

And the biggest application for this technology is BlueCruise and ADAS. It's a leading hands-free driving technology in America, we believe. We now have 415,000 enabled vehicles on the road. That's a 25% increase in one quarter. We have 213 million miles, three-million-plus hours of hands-free driving now since launch.

To better dimension our progress of software technology and services; in the quarter alone, total company paid subscriptions grew 40% to over 765,000 paid subscriptions. Our integrated service revenue is now on track for double-digit growth this year. We are targeting \$1 billion of revenue next year for our software. This revenue has gross margins of 50-plus-percent, which drives significant operating leverage and improved capital efficiency.



Jim Farley (cont'd)

Now the major part of this new software business is actually Ford Pro, so let me touch on that. The foundation of Pro is really simple. It's our vehicles. A robust and fresh lineup, the freshest we've ever had at Ford of ICE, hybrid and EVs, including the all-new Super Duty, the all-new Ranger globally, the all-new F-150 that has just finished its launch, the all-new custom Transit in Europe, and our two small vans in Europe, the new Transit Connect and Courier, and the new extended-range two-ton electric Transit we sell in both Europe and North America. Now what these brands and vehicles are seeing is resilient revenue streams based on a much longer tail spending on the infrastructure by government and private enterprise.

We also have a very robust and diverse customer range. We dominate in small business and medium business with tradesmen, but we have very large customers. We have state, local and national governments. And we have rental, which by the way, is very profitable for Pro. In fact, in the U.S., one out of four of these fleets, mom-and-pop tradesmen, all the way to large companies, one out of four of those fleets in the U.S. are Ford only. But the big opportunity for Pro is beyond vehicles and that's where we're focusing. With Pro Power Intelligence, we have a highly differentiated telematics offering. We offer real-time driver coaching, which provides significant improvements for driver safety and now is available in about half of our modem-enabled Pro vehicles.

This includes features like seatbelt and speed monitoring and harsh braking notification. Pro Intelligence is also a platform for vehicle controls. Our first foray, it's a big deal, is Fleet Start Inhibit, which protects our Pro vehicles from theft and also unauthorized use. We will expand these vehicle controls to speed control and acceleration limits in the near term.

Now, no third-party telematics solution can offer this functionality, because it's related to the vehicle. We call it an un-crossable moat for our software business. Over four billion miles have now been traveled in the first half of this year on vehicles equipped with Pro telematics, insights and controls. And our paid subscriptions for Ford Pro Intelligence grew 35% year-over-year, now including 610,000 paid subscriptions with a triple-digit growth in telematics fleet management and charging depot software.

Turning to physical service, which is the second big non-vehicle revenue and profit for us at Pro, we have a massive opportunity to grow physical services of parts. In the first half of this year, Ford Pro was only 24% of our after-sales revenue. It's a huge upside. Bank of America estimated the profit pool for maintenance, repair and parts, physical repair of the vehicle that escape our dealer network is about \$135 billion. That's 2.5 times the profit dealer's capture through vehicle sales and financing. This is a huge untapped TAM.

Ford Pro already has the largest physical and mobile service network in North America, but for specialized commercial service, many of which is open 24/7 for our customers with specialty technicians. And we continue to expand that physical network to a competitive advantage by adding Pro Elite centers and mobile service units. We are on track this year to reach 27,000 commercial service bays by the end of this year. That is up 20% year-over-year.

Growth will be led by Elite bays, the largest and most capable of the service base for Pro, which will more than quadruple this year to 1,300. We are now on track to increase our mobile service units by 45% to 2,500 service trucks and vans. That's 10% of our entire physical network. Mobile



Jim Farley (cont'd)

service network is incredibly important competitively. None of our competitors offer this kind of scale. We address many repairs, limiting our downtime for our customers.

We service multi-make fleets, which helps us with our share of garage unlike our competitors. And global mobile repair orders that generated from this fleet is up 115% in the quarter. Our focus on software and physical service expands the moat for Pro, while helping our customers improve productivity and grow their business. Pro is on track for software and physical services to contribute 20% of our EBIT by 2026.

On quality, we're making progress with our latest vehicles. Ford jumped 14 points in the latest JD Power's 2024 U.S. Initial Quality survey. We went from 23rd in the industry to ninth. Bronco Sport is now named the best small utility in initial quality, outperforming 18 competitors. Our launch in initial quality are leading indicators for warranty in the future and we expect to see benefits in the future.

We did see warranty cost increase in 2Q, of course, tied to new technologies, FSAs and inflationary pressures for the cost of repair. We expect technology-related warranty costs to now normalize, as technology matures and we deploy that great OTA capability to address known issues. We are confident we are on the right trajectory with a very clear and non-negotiable mission at Ford to deliver best-in-class quality.

I'll close with this. The remaking of Ford is not without growing pains, but is unlocking opportunity to serve our customers in growing ways we never thought possible. My confidence comes from the fact that we have built a world-class team, and we are executing a compelling strategy. No other company has Ford Pro. We intend to fully press that advantage. No company has a more compelling product lineup with an attractive mix of ICE and partially and fully electric options for both work and retail customers.

We also know we have a lot to prove. We look forward to proving our EV strategy out. That has become more realistic and sharpened by the tough environment, thankfully, we scaled years ago. We are confident we can reduce the losses and sustain a profitable business in the future with everything we've known. We look forward to proving that we can be profitable on smaller vehicles as well, not just on EVs, but across all of our powertrain choices. It's time to prove our recent quality gains are repeatable and will flow to the bottom line. Plenty of work ahead, but the direction is crystal clear to us. We are building a high-growth, high-margin, more capital-efficient and more durable Ford. John.

John Lawler

Thanks, Jim. And I want to thank the entire Ford team for their hard work and continued focus on executing our Ford+ strategy. And more importantly, we are working aggressively to remake Ford into a higher-growth, higher-margin and more durable business as you said, and frankly, a higher-performing company. Our automotive business is solid and consistently generating strong free cash flow, which is a core ingredient to drive total shareholder returns over time.

Now in the quarter, we generated nearly \$48 billion in revenue, with growth of 6%. Wholesales were up 2%, as our fresh and compelling product line gave our retail and commercial customers unmatched freedom of choice. The quarter benefited from record Transit wholesales, as well as



John Lawler (cont'd)

the completion of our all-new F-150 launch, including drawdown of the inventory we had held at the end of the first quarter.

We delivered \$2.8 billion in adjusted EBIT, with a margin of 5.8%, as higher costs were partially offset by the continued strength in Pro. Costs were up year-over-year, primarily reflecting an increase in warranty reserves, higher new product-related material costs and higher manufacturing costs.

Now if you take a step back and look at our sequential performance, Q2 saw revenue growth of 12% on a 9% increase in wholesales, driven by higher truck volume and the strength of our product portfolio. Despite this revenue growth, EBIT was flat, reflecting primarily higher warranty and manufacturing costs related to the inventory, which was driven by seasonality and the high-volume launches.

We remain on track to deliver \$2 billion of material, manufacturing and freight efficiencies over the full year, which will partially offset higher labor and product refresh costs. We are seeing emerging headwinds in warranty and inflationary pressures in Turkey, and we are working to mitigate these costs.

Now, I have more confidence in today's business than ever. Our strong global product lineup is differentiated and driving continued top-line growth. And we're slowly but surely improving our industrial system and shedding behaviors that have held us back in the past. We're on track to deliver our full year guidance, and we are generating stronger and more consistent cash flow than just a few years ago, evidence that our Ford+ plan is working.

Adjusted free cash flow was \$3.2 billion in the quarter and \$2.8 billion through the first half, resulting in a cash conversion rate of 51%. Our \$1 billion increase to adjusted free cash flow guidance for the year underscores our growing confidence in the business.

Our balance sheet remains strong with close to \$27 billion in cash and \$45 billion in liquidity, providing considerable flexibility in a very dynamic environment. I'm also pleased to announce that we declared our third quarter regular dividend of \$0.15 per share payable on September 3d to shareholders of record on August 7th.

Now let me spend a few minutes summarizing the financial performance of our customer focus segment and highlight how each of them is driving Ford+ and making our business stronger. Ford Pro delivered a 9% increase in revenue on a 3% increase in wholesales. The segment has consistently delivered year-over-year revenue growth each quarter since we re-segmented our businesses.

EBIT was a solid \$2.6 billion with a healthy margin of over 15%, reflecting increased Super Duty and Transit volume that are both capacity-constrained along with higher net pricing. Ford Pro is the prototype for sticky high-margin, non-cyclical revenue. Pro's results this quarter continue to demonstrate consistency, predictability and resiliency of this higher-margin growth business.

Ford Model e generated a loss of \$1.1 billion as continued industry pricing pressures and wholesale declines of 23% more than offset lower cost. Our team's intense focus on cost



John Lawler (cont'd)

delivered about \$400 million in savings to the bottom line in the quarter. Key factors included reductions in material costs, improved battery economics and lower engineering. This builds on the cost reductions we have achieved since the launch of our first-generation products, helping to improve our profit outlook as we head into '25.

Ford Blue revenue grew by 7% on a 3% increase in wholesales, led by growth in trucks and strong pricing. Wholesales were impacted by the launch of the Explorer as we ended the quarter with about 21,000 vehicles in inventory for quality checks. EBIT of \$1.2 billion and a margin of 4.4% were both down year-over-year, mostly driven by higher warranty. Once again, Blue was profitable in every region. Our hybrid sales, up 34% in the quarter, continue to shine and our global hybrid mix is now approaching 9%, up over 2 points year-over-year with more products on the way.

Ford Credit generated EBT of \$343 million, down slightly year-over-year. As expected, auction values declined by 9%, and lease return rates continued to normalize from historic lows. Credit losses and insurance losses were also higher, but mostly offset by an improvement in financing margin. We continue to originate a high-quality book with U.S. retail and lease FICO scores, again, exceeding 750 for the quarter. Our exposure to EV residual risk is low as EVs represent less than 5% of our lease portfolio.

For now, let me turn to our outlook. As I referenced earlier, we continue to expect full year company adjusted EBIT in the range of \$10 billion to \$12 billion. In general, we see supply and demand for vehicles in balance. And industry dynamics, including market equations for our four segments, are playing out similar to what we forecast at the beginning of the year. We are increasing our adjusted free cash flow guidance by \$1 billion to \$7.5 billion to \$8.5 billion, supported by strong earnings and lower-than-planned CAPEX. We are keeping our CAPEX target range of \$8 billion to \$9 billion and are focused on delivering at the low end.

Our outlook for the year assumes a flat to slightly higher SAAR in both the U.S. and Europe. Our planning assumption for the U.S. is 16 million to 16.5 million units. Full year of customer demand for all-new Super Duty contributing to better market factors for Ford Pro. Lower industry pricing of roughly 2%, driven by higher incentive spending as we move through the second half of this year. For Ford, we expect this to be partially offset by top-line growth from the launch of our new products, warranty reserve increases from software, higher repair costs and FSAs.

Our segment outlook anticipates continued Ford Pro strength, and we are increasing our EBIT range to \$9 billion to \$10 billion, reflecting further growth and favorable mix, partially offset by moderated pricing. As expected, losses in the range of \$5 billion to \$5.5 billion for Model e, driven by continued pricing pressure and investments in new vehicles. And for Ford Blue, we are trimming our EBIT range to \$6 billion to \$6.5 billion, reflecting a balanced market equation and higher warranty.

We expect Blue's profit trajectory to significantly improve in the second half, reflecting higher volume with the F-150, Explorer, and Ranger launches that we've just recently completed, and our recent capacity expansion on Bronco. And we expect Ford Credit's EBT to be about \$1.5 billion, double-digit growth year-over-year.



John Lawler (cont'd)

Now our performance this quarter demonstrates the positive progress on our Ford+ plan. We're disciplined with capital, and we have the right portfolio of products, and we are delivering consistent cash generation to reward our shareholders. We are relentlessly seeking out new ways to make our business better and remain focused on driving improvements in both quality and cost.

So that wraps our prepared remarks. We'll use the balance of time for questions. Thank you.

QUESTION AND ANSWER

Operator

We will now begin the question and answer session. To ask a question, you may press "*" then "1" on your telephone keypad. If you are using a speakerphone, please pick up your handset before pressing the keys. To withdraw your question, please "*" then "2."

Your first question comes from the line of Adam Jonas with Morgan Stanley. Please go ahead.

Adam Jonas

Hi everybody. Jim, you said that Ford is a different company from what it was three years ago, but the stock market really doesn't seem to agree with you at all on that. Stock is down about 10% after hours and around \$12 a share. And my team just ran the numbers, Ford ranks 494 out of 500 companies in the S&P on PE. Jim, do you...my first question is, do you think Ford's stock is good value?

Jim Farley

Yes. Yes, we're...

Adam Jonas

Then why does your...then why does your Board refuse to authorize a share buyback? And people on this call, I think they understand the reason, like the family element. But in your opinion, if you're telling me the stock is at good value, and it's like the bottom one-percentile of the S&P, what's the plausible reason why...do you really think you have better uses of capital than that?

Jim Farley

Yes, we do. And I have to tell you that it's hard for people to understand those possible uses of capital, but we have so many exciting businesses to invest in. And Pro is a great example. I'm not going to get into specifics, Adam, but I think people will understand over time how many exciting opportunities there are at Ford. And I'm not just referring to vehicles, I'm referring to non-vehicle activities. We have 27,000 service bays. There's lots of opportunities. And as I said, when you look at Ford Pro, I'll just deep dive on that one, and I'm so glad you asked this question, by the way. So Ford Pro is a very, very high percentage of our company's profit. Just look at the ratio between the overall company's EBIT in Pro and our guidance.

And then think about our after-sales business, only 24% of our revenue comes from Pro-related vehicles. And we could spend a lot of time talking about this opportunity, but that's why I highlighted it in my comments, there are so many places for us to grow Pro on the physical services. They're like 35% margin, but it's hard stuff, right? It's like bays and technicians and a



Jim Farley (cont'd)

lot of work. We have very exciting electrical architecture investments that we have to make in our future that will really change our ICE vehicles and their revenue potential. Because that revenue won't be just when we sell the vehicle, it will be over time, which we're seeing with Pro already. So I don't want to belabor the point. I'll just tell you there are plenty of opportunities. Anything else?

Adam Jonas

Okay. Just a follow-up on Skunkworks.

Jim Farley

Yes.

Adam Jonas

Your team has made a number of visits to China over the last couple of years, including, I think, just a couple of months back, I believe, you were there. What are you learning from these trips? And specifically, I mean, you mentioned China along with Tesla are the cost benchmark, but do you think Ford can bring to market a low-cost EV profitably without help from your partners in China or is China part of the solution? And if China is part of the solution, then what are you going to do about it?

Jim Farley

Yes, great question and an important question for any OEM as the EV market evolves here. Look, we made the bet on CATL many years ago. It was a very important bet for our company to localize LFP cells in North America happen to be in Michigan. We're two years into that project. That is a signature partnership. CATL is the largest battery maker in the world, and they lead iron phosphate cost and reliability. That is a signature partnership that we launched many years ago that we've been working hard on, and Marshall is on track.

Look what Volkswagen is doing with XPeng, and many others who are kind of taking a Chinese low-cost platform and using that. That's not our strategy. Our partnership strategy will be on the component side, going deep into the supply chain for IP that is critical and unique. I'm not going to get into specifics, but CATL is one example, and we're going to learn how to do that at the company. We believe that this is essential know-how for the company because the true fitness test for EV profitability will be on these small vehicles. And we have learned from our experience with Mazda and KIA and many others that we have to have this know-how in the company because it applies across all of our vehicles, not just EVs. And the lowest cost is the most important capability.

We believe that many of our competitors will turn to their Chinese, either independent companies or partners to basically use their platform globally. We learned a lot, not just from China, but from MEB. We've been scaling MEB. We know the cost of Volkswagen. They're one of the leaders in scale. And what we found in that trip and subsequent trips to China is that we have a very competitive battery with CATL, but many of the Chinese players in the lower-cost have very affordable batteries, but they don't have the most efficient design outside of the battery on the other EV components.



Jim Farley (cont'd)

And our team, the Skunkworks team, we might as well call it a big team now because it's no longer Skunkworks, we're betting on them as our affordable platform. They have really designed breakthrough EV components with our own design that we think are better and cheaper. And we have a very competitive battery localized with the IRA benefit. And the partnership discussion, I think, will...we think will largely put out in larger vehicles. We think that's where the partnership...big partnership opportunity really lies. In the commercial vehicles that I talked about, I'm not...we have nothing to say right now, but this is...we...why is the partnership so important? Because the bigger vehicles have this kind of inverted cost, and the partners allow you to be more capital-efficient and have better returns. And that's why we think that the partnerships on larger vehicles will play out as vibrantly as affordable vehicles.

Operator

The next question is from Bruno Dossena with Wolfe Research. Please go ahead.

Bruno Dossena

Yes, thank you for taking the questions. I was wondering if you could just contextualize what fundamentally within the organization you think is leading to these persistent warranty issues. And I realize partly it's because it was on a prior industrial system, but just given how frequently the surprise warranty issues keep popping up, how do you have visibility or how can investors really build confidence in an earnings trajectory when, every year the surprise warranty issues keep happening? Thanks.

Jim Farley

Thank you. I think the most important evidence, the J.D. Power's IQS, that's a really big point of evidence for everyone. Our internal data, by the way, had been saying that for quite some time. It's now verified. I think that is clearly cutting the initial quality defects to a fully competitive rate, where we're leading some segments, will clearly bring our warranty down over time. But it takes...as you said, it takes time. You've got to launch vehicles, you've got to get in the industrial system and make sustainable changes.

The other one I would say is, as painful it is quarter after quarter to have all these great launches, we do not release them until we're happy with the quality and that we've done all the testing. And it makes our quarters lumpy and it's challenging, but it will reduce warranty over time. When you look at the root causes for these issues, and I can go through the hundreds that we go through, it's very clear that these are issues many of which we could have caught at launch. And that is what's happening now at Ford. We have to go through all these launches to find these, and over time we're confident they come down.

The other thing we maybe made it more difficult in a way, but better for the company fitness-wise, is we put a lot of new technology in our vehicles. And that new technology is difficult for the dealers to diagnose when customers come in and say something is wrong with my SYNC system. They replace modules unnecessarily, et cetera, and that hits our warranty reserves. What we've found though is that this kind of fixing is different than mechanical fixes, where that OTA capability redirected to these defects can really reduce our cost outlays for the warranty...against the warranty reserves. And we're working all of those cost curves every day for each of our models.

John, anything to add?



John Lawler

Yes. I think that, there's the lag that you're going to have between the quality improving and the warranty run rates improving. And so, the first step, as Jim said, is the quality improving and we're seeing that in the physicals now. And that lags, you know, 12 to 18 months and we should start to see the warranty coming in. On the prior models, the majority of what's coming through our FSAs, we're doing things to fix those quicker, get out in front of them, reduce the impact of them, but we're working that every day. And it's an issue that the team is focused on, and the encouragement is that the quality is improving and that is the most important thing for the future of the business and the longer run rate of the business.

Jim Farley

What we won't do at Ford is reduce our actual cash expense at the expense of our customers. We will fix these problems. We will do the right thing. I don't care if it costs rental cars or whatever. We want to turn these quality issues into positives for our customer experience.

Bruno Dossena

Okay, thank you. So maybe to step back, and I think this touches on Adam's Skunkworks questions, but when you compare Ford down to history, earnings are now significantly higher. But the capital base has expanded such that returns really haven't improved. And this isn't just Ford. This is most Western automakers. The earnings part of the equation is only partly in your control, but the structural costs are. So how are you thinking about the trajectory of structural costs from here, even simply, are they going up or down? And B, given this is a similar dynamic for a lot of automakers, and so many traditional automakers are investing billions in R&D, really trying to achieve the same thing with respect to EVs, make an affordable EV at scale to compete with Tesla and Chinese OEMs, why do you think the legacy OEMs are all doing this by themselves? And why aren't there more partnerships? Thanks.

John Lawler

Well, I would say that you have to think about how you're going to fundamentally change the development process. I think that's the core thing. It's not necessarily just doing it with somebody else. Sure, we're looking to be as capital-efficient as possible, bring partnerships in for capital, but you can do that on components and you can do that in other ways as well. And we know and we've done a lot of work understanding what has kept this industry kind of in that penalty box that Adam was talking about, as you mentioned. We're not capital-efficient, we're lower-margin, we don't grow enough and, we're not resilient and it's a very cyclical business, and we're working to change that. We've walked through the areas that we're doing and attacking to improve those key areas.

But it's really about the efficiency of the design, and the Skunkworks team is doing something very different. That team is unique for a traditional OEM, the talent on that team. They're doing an agile waterfall systems integrated design process, which no other global OEM has done, a traditional OEM. And we're really working that to be focused on what can happen from a tech standpoint as well. And that vertical integration really helps us drive to those lowest costs. And we're finding that there's ways to be more efficient in many ways than some of the Chinese by incorporating the technology that the team is able to bring forward and leveraging the know-how that they've had from the last products that they've put forward.



John Lawler (cont'd)

So, I think there's a lot of opportunity for us with that team and the talent and the change in the process that's not only going to show up when we get to our affordable EVs that are going to come from them, but it's also important to understand that if you don't have that transfer function Jim talked about, the entire company isn't going to improve. And by doing it within the company with that team, we have a much higher probability of that transfer function being successful.

Jim Farley

Yes. And I would just emphasize that the ambition at Ford for partnering on EVs is record level high. We're not going to make any announcements in earning call, but this is absolutely a flip-the-script moment for our company. We have done partnerships like Volkswagen. We have learned how successful...how to be successful with the one-ton Transit that includes an electric vehicle. We really see that opportunity in front of us. But we are not going to partner to the level where we delegate our future and the future fitness for cost competitiveness outside the company. We need...and if we have a partner, we have to have that transfer function that John mentioned.

I would only say that we need as an industry to start focusing equally on the one-time cost investment in the electrical architectures and the transition to digital products. Now, the integrated services that we're finding, we have 765,000 paid subscriptions. They were different than our competitors who just basically do it for infotainment. We are basically, you know, productivity on Pro as well as BlueCruise. And to take that to the next level, make that business supercharged, we need to invest heavily in electrical architectures, not just on our EVs, but also in our ICE vehicles and hybrid vehicles. And that will be a one-time investment. And the benefit of that was what I was trying to highlight in my script, which is when the economy turns down, we still have those subscriptions. Our service business, customers turn to that even more in a downturn because they keep their vehicles longer, they have to do more maintenance. These are ways to kind of de-risk our exposure to economic cycles.

And we have to make OTA, the updated IVI system, the integrated services team, both B2C and B2B, our electrical architectures. These are all basic enablers that go beyond EVs. And the industry is going through that transformation too, and I believe Ford is in advance of others because we have more complicated platforms than Rivian and many...and Tesla and many of the other OEMs. And because of that, we also have more scale. We have more complexity, but we have more scale. And I think that transition and kind of structural change in the industry is as big as the EV change. We're going to get to \$1 billion of revenue, we think, next year on software. I wouldn't have thought of that two, three years ago.

Operator

The next question is from John Murphy with Bank of America. Please go ahead.

John Murphy

Good evening, everybody. Just to take it back to more sort of the core of the business. Jim, I just wanted to go through some numbers or kind of your take on the Ontario Super Duty capacity add. I mean, obviously, it's a big step-up in capacity for the Super Duty 100,000 units. It seems like current demand would certainly soak that up or absorb that reasonably easily. But I'm just curious, if you think we might be hitting sort of a peak in this truck, what's your sort of view on the ability to kind of sustain these high levels of demand and sell-through? How should we think



John Murphy (cont'd)

about incremental margins on that? Because it seems like a \$3 billion investment might have a payback of less than two years and then spin out a lot of cash real quickly, so it might be a really, really, really good investment. So I was just wondering if you could talk about that and then also what kind of powertrains those trucks will have?

Jim Farley

Yes. Thank you. So powertrain-wise, it will be a diverse powertrain, multi-energy platform. I'm not going to get into specifics, but you can imagine what we've done with F-150 and Transit Van, we've gone to...and all of our commercial vehicles, a multi-energy platform. So we will offer customers the choice that we think no other competitor will have. And we're...we believe we'll be a first-mover, if not the first-mover in multi-energy Super Duty. Look, we saw the \$1.2 trillion investment in Infrastructure and the Jobs Act. That is coming home. There's a 5G upgrade that's going now. I think it's close to \$300 billion investment. And I think what's...I'm really glad you asked this question, John, because it's not obvious to people.

The real part of our Super Duty business that is...that has been under constant, supply strains is our chassis business. It's about 25% of our entire Super Duty business, but they are not pickup trucks that people use like what you think in road construction. These are people with bucket trucks doing 5G upgrades, heavy construction. And that is the demand that we have not been able to fill. Ford is...and I'll give you an example. We dominate ambulance in the U.S. Ambulances tend to use our Super Duty chassis business. The average age of an ambulance in the U.S. is 15 years now. They're all falling apart. We have not been able to service that industry, and now we can with this incremental capacity. And so it's an aged fleet, the chassis business. It's got a ton of investment tails to it still. And we lead in the industry because of our upfitter in the products. And now we're going to take the lead on the multi-energy part. That's kind of the story, and it will be a great payback. And we wouldn't be doing it at Ford unless we thought this demand would last for many, many years to come, John.

John Murphy

Okay. And if I could sneak just one more in, maybe for Cathy, on the used residuals or the residuals at auctions. It seems like although down year-over-year, the last three quarters, they've stabilized and started to improve. I'm just curious what your outlook is there and it just seems like the supply is going to remain relatively constrained in the used market, the late-model used market. So this might be a good guy, not just for Ford Motor Credit, but for residuals and potentially, a lift or support for new vehicle pricing. So, just what are your expectations there and what are you seeing in the market, Cathy?

Cathy O'Callaghan

Yes. So we're seeing auction values down about 9% this quarter year-over-year, but up sequentially about 3%. We're expecting auction values to continue to decline in the second half of this year, and we're also expecting our return rates to increase as well in line with that.

John Murphy

Great. Thank you.

Operator

The next question is from Dan Levy with Barclays. Please go ahead.



Dan Levy

Hi, good evening. Thank you for taking the questions. I wanted to start first with a question on Pro where we're seeing these continued strong results and really pricing is doing a lot of the strength. So I understand all the bits about, pent-up demand, and that's really helping and there's really a thirst for these products, but maybe you can help give us some color on the sustainability of this pricing...product pricing. And specifically, A, how long is this tale of pent-up demand? B, how much of the pricing is contractual versus, let's call it more spot retail, which would be more subject to the market fluctuations? So any color on the trajectory of pricing in Pro given it's had such a strong run.

John Lawler

Yes. So when you look at Pro, we've been talking about the fact that the demand-supply imbalance has been great for the top line and it's been running pretty strong, right? No surprise there. We have been forecasting that we expect as we move into the '25 model year that there will be some of the top line coming off. And that's in our guidance.

So we understand that over time, that's going to get chipped away a little bit here and there. But we also believe that there are very underserved segments like chassis that we're going to be able to provide product to, where there'll be more price stability as we move forward. So we don't see prices collapsing.

Now when you look at our business, about, I would say, 60% of it or so comes from the fleets, which are negotiated on an annual basis. Those have remained very strong the last couple of years. I've talked about in the past that we'll start to see what the '25 model year contracts look like as we move through the third quarter, initial indications are continued, demand beyond what we can supply, but we'll work through that and we'll have an update as we come through third quarter. But we're seeing demand continue both on the typical fleet contracts as well as through the dealers when it comes to the smaller fleet customers, the fleet tail, we call it, where they're buying two or three vehicles at a time. So we're watching this very closely, but so far with '25, early indicators are positive, but we need to really move through that process much deeper before we can say where '25 is going to fall out.

Jim Farley

I wish there were car wars for commercial, because if there was, we would see the product freshness at Ford be an outstanding situation for us. So aside from kind of the industry backdrop of the industry pricing and the demand, I think one of the most important decisions we made several years ago is to go full in on Pro. So we invested in a one-ton Transit, which is our profit machine in Europe. We invested in new Ranger globally. We invested in a brand-new Super Duty, including chassis, including multi-energy. We invested in new F-150, and we have all these new electric Transit, two-ton Transits. That was very intentional. We did it several years ago and now that will pay off, I believe, as we look into these multi-year contracts. And I...for Ford at least, it's very important to understand how outsized the freshness of our lineup is at Pro. I've been here 16 years, I've never seen all of our core products updated within a 12 month period like this.



Dan Levy

Great, thank you. That's helpful. As a follow-up, Jim, I'm wondering if you could just address the electrification strategy in light of the November presidential elections. We know, obviously, there's one candidate who's talked about pulling back on the EV mandate, and there could be some implications on IRA or the federal or California mandates. I appreciate you've talked about the need to have flexibility, and I think you even referenced earlier on the call, that credits will play a role, but maybe you could give us a sense of where the strategy is. Is your strategy one that's more existential that...and clearly with Skunkworks, it seems to indicate that it is, versus a strategy that is maybe one that's just more meant to reach compliance with a long-term...longer-term goal in mind, but maybe you can give us a sense of how the strategy might change, if at all, depending on the outcome of the elections.

Jim Farley

Yes, thank you. Obviously, Ford has had a lot of history...a lot of experience and wisdom after 120 years of elections. And I would say, think about our strategy this way. We believe that the fitness of the Chinese in EVs will eventually wash over our entire industry in all regions. And so, we believe, as a company, even if there were short-term adjustments we can make to a compliance-led, lower requirement lineup, we're not going to approach it that way. We really believe what I said, which is that many Americans would find an electric vehicle lowering the cost, not everyone, but a high percent.

And we believe that to be fully fit globally, whether it's our Ranger business, our commercial business, anything really, we have to find a way inside the company to be fully fit with lots of partnerships on the supply chain side. And so this is a kind of enduring strategy at the company. It is not a strategy where we handicap the presidential election for the next one and the next one and see what we can get away with the EPA, that is not how we run Ford because Ford has...Ford didn't go bankrupt. We have been enduring. And the only way we believe to be enduring is to make money on small EVs and commercial and that's our bet. You'll see it play out in coming years. It's a big adjustment from our Gen 1 products. I'm glad, as I said, we scaled 2.5 years ago because we could learn about the reality of the market equation, which is just requiring us to be more fit and move faster.

The EPA could certainly change, but it would take, as John said, several years for...through legislation and lawsuits for that to change. So even from a compliance standpoint, we can't really count on administrations changing this way or that way. I've been to the Hill many times in the last month, talking to many Republican leaders of the country, and I always say the same thing to them. Please realize that there's a subset of customers that absolutely would save money, and they're also, absolutely, a group of customers who like partial electrification.

And Ford's strategy is choice, manufacturing flexibility and choice. We are not going to bet student body left on this or right. We are going to give customers choice. We're going to be flexible manufacturing. That's why we want to be a first-adopter to an EREV or whatever is next on partial electrification because we want to be first and best at that choice. But on EVs, we need to be fully competitive with BYD, Geely, even our old partners Changan. And the only way for us to have done that is through this small group in California.



Dan Levy

Great. Thank you.

Operator

The final question today is from Ryan Brinkman with Barclays. Please go ahead.

Ryan Brinkman

Hi, Ryan Brinkman from JP Morgan. Thanks for squeezing me in. I wanted to ask on the warranty performance that led to the higher cost. I remember a similar issue with higher warranty expense back in 2022, which you then tied to, I think, a transmission installed on vehicles some years prior while noting that the quality on vehicles built more recently had improved. So, I know you're prioritizing initial launch quality, including with the F-150, you discussed at length last quarter, but really any color you could share would be helpful such as, whether the higher warranty provision this quarter relates to a discrete issue like in 2022, or maybe you could share what age cohort of vehicles is driving the higher cost this quarter. And then with that new provision, do you think you've got a better handle now on what future costs could be and the provision in future quarters, it could normalize lower as soon as next quarter, or how would you rate the potential for quality performance in older vehicles to maybe surprise negatively again?

John Lawler

Yes, Ryan. I mean that's part of the issue is these are issues that are popping up in the field on these older models. The largest one coming through is on a rear axle bolt for vehicles that were engineered for the 2021 model year was when they were introduced. And if these things come through, at a higher time in service, we're made aware of them, we need to take care of our customers, we go out to fix them. And we have several of those types of things popping up on older models. We got a failed oil pump issue that's popping up on, 2016-launched vehicles.

And so, it's clear that we had a period of time where the robustness wasn't what it needed to be and that's showing up. And it is hard to predict on some of these units that have been out in the field for quite a while that one of these issues is going to show up, these longer-term durability and quality issues. But we need to work through that. And we do believe that overall, as we improve our near-term quality and that starts to show up in the field, that will allow us to, based on the rules that we have around how we do our accruals, bring down that overall accrual level. So these types of issues if they pop up will have less of an impact overall because our run rate on quality will be improving.

Ryan Brinkman

Okay, thanks. And maybe just a follow-up on how your comments there might relate to what Jim was saying earlier about Ford controlling the software stack from bumper to bumper, from all the over-the-air update capabilities. What do these new capabilities mean for your ability to troubleshoot or prevent warranty issues in the future?

John Lawler

Those are critical too. When you look at some of these things, that have been out in the field for a while that have failed, they crossover...let's say they launched in a '16 model year was the first year it was done. So it was designed and engineered in '13, '14, '15, launched in '16, and it's been out there for quite a few years. With the connected vehicle and having the digital electrical architecture and us controlling the software across all of the operating domains, we will be able



John Lawler (cont'd)

to get signals off the vehicle early to tell us whether or not we're having an issue in certain components.

And if we understand that early, we can understand the cause of that and then we can go out and minimize, reduce, get out there earlier and reduce the number of vehicles that are impacted and actually either do an over-the-air update, if we can fix it that way, or do a preventative maintenance type program for folks, which will be much cheaper than a field service action recall where you're replacing components and modules, et cetera. So there's a lot of advantages through that connected data that we'll be able to run through warranty...the warranty system, that's more on the physical side. On the software side, we'll be able to understand, when things are an issue much earlier and we'll be able to fix them through over-the-air updates, which will be a much lower cost as we move forward.

Jim Farley

And during our launches, Kumar and Doug have partnered in a way that hasn't been done at Ford for a while at least, where we are testing vehicles to failure and individual components to failure, which is not our launch standard, but we are now doing that. And we are also looking at the DTC codes off the vehicle, especially powertrain DTCs, and running these vehicles at extremely high mileage, far beyond our standard for launch. And that has caught many, many issues in our industrial system that we've been able to correct before we release the vehicle. It's painful to have all these vehicles over quarter ends, but it's the right thing to do for the company and it is the only way, we believe, in addressing our warranty spend.

Ryan Brinkman

Very helpful. Thank you.

CONCLUSION

Operator

This concludes the Ford Motor Company's second quarter 2024 earnings conference call. Thank you for your participation. You may now disconnect.