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ST - Q3 2017 Sensata Technologies Holding NV Earnings Call

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PRESENTATION

Operator

Good day, and welcome to the Sensata Technologies Q3 2017 Earnings Conference Call. (Operator Instructions) Please note this event is being recorded. I would now like to turn the conference over to Mr. Joshua Young, Vice President, Investor Relations. Please go ahead.

Joshua S. Young - *Sensata Technologies Holding N.V. - VP of IR*

Thank you very much, Carrie, and good morning, everybody. I'd like to welcome you to Sensata's Third Quarter 2017 Earnings Conference Call. Joining me on today's call are Martha Sullivan, Sensata's President and CEO; and Paul Vasington, Sensata's Chief Financial Officer.

In addition to the earnings release we issued earlier today, we will be referencing a slide presentation on today's conference call. The PDF of this presentation can be downloaded from Sensata's Investor Relations website, and we will also post a replay of today's webcast shortly after the conclusion of today's call.

Before we begin, I'd like to reference Sensata's safe harbor statement on Slide #2. During the course of this conference call, we will make forward-looking statements regarding future events or the financial performance of the company that involve risks and uncertainties. The company's actual results may differ materially from the projections described in such statements.

Factors that might cause these differences include, but are not limited to, those discussed in our Forms 10-Q and 10-K as well as other subsequent SEC filings.

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On Slide #3, we show Sensata's GAAP results for the third quarter of 2017. We encourage you to review our GAAP financial statements in addition to today's presentation.

Most of the subsequent information that we will discuss during today's call will be related to non-GAAP financial measures.

Reconciliations of our GAAP to our non-GAAP financial measures are included in our earnings release and in our webcast presentation.

Additionally, the company provides details of its segment performance on Slide 10 and 11, which are the primary measures management uses to evaluate the business.

Martha will begin today's call with an overall business summary. Paul will then cover our financials for the third quarter of 2017 and provide guidance for the full year and fourth quarter of 2017. We will then take your questions after our prepared remarks.

Now I'd like to turn the call over to Sensata's President and CEO, Martha Sullivan.

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

Thank you, Joshua, and thank you all for joining us this morning. I am pleased that Sensata once again reported strong results in the third quarter of 2017. Strength in China, combined with momentum in our HVOR and industrial businesses, continue to drive our top line performance, while M&A cost synergies and lower integration costs are delivering strong margin expansion and earnings growth.

I will begin on Slide 4. We reported revenues of $819 million, representing organic revenue growth of 3.6% in the third quarter of 2017, exceeding the high end of our guidance. Both of our segments generated solid results in Q3 as Performance Sensing posted 3.1% organic revenue growth, and Sensing Solutions reported 5.2% organic revenue growth.

The key drivers of our overall revenue growth continue to be China, particularly in our automotive business as well as our HVOR and industrial businesses. We expanded our adjusted EBIT margins by 90 basis points compared to the third quarter of 2016. This has continued a trend of strong year-over-year margin expansion throughout 2017.

We delivered another quarter of double-digit adjusted earnings growth, posting growth of 10% in the third quarter of 2017. This performance was the result of improvements in the profitability of our acquired businesses and lower integration costs. The earnings power in our business model due to M&A cost synergies should continue to drive attractive earnings growth in the fourth quarter and into next year.

Many of you may have seen that on September 29, we announced our intention to re-domicile the company to the U.K. This announcement was another key highlight of the quarter. Should the re-domicile be approved, we believe that this move will provide Sensata with a number of benefits, including greater flexibility for our capital deployment initiatives, while maintaining our attractive tax position.

Sensata has deployed capital toward high-returning M&A and share repurchases in the past. More recently, we have focused on reducing net leverage. Going forward, we expect to have a balanced approach to capital deployment that maximizes shareholder value at an appropriate net leverage range. Our move to the U.K. will help to support this more balanced approach.

Finally, Q3 was yet another strong quarter of new design wins. The trend was particularly strong in our auto business as customers are increasingly adding new sensor content for exhaust treatment in gas vehicles and braking systems in electrified cars as a result of the need for improved safety, efficiency and a cleaner environment.

Slide 5 shows our organic revenue growth by end market, starting with our fastest-growing businesses at the top of the slide. HVOR once again outpaced the end market growth, posting organic revenue growth of nearly 20% in the third quarter of 2017.

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Within HVOR, both our on-road and off-road businesses grew double digits, with particular strength in our construction and agriculture end-markets and stronger content growth. We are executing against a healthy backlog of design wins in HVOR, which provides us visibility into sustaining attractive growth rates into the future. As we project for the remainder of the year, we expect underlying production in the HVOR market will grow 5% for the full year 2017. As a result, we expect that Sensata's organic revenue growth in these markets will outpace production, which reflects the strong content gains we are making with our expanded portfolio.

Next, I want to turn to industrial, HVAC and other end-markets, which are served by our Sensing Solutions segment and represent approximately 25% of Sensata's total revenues.

In the third quarter of 2017, we generated 5.2% organic revenue growth in this segment of our business. The drivers of this solid performance are healthy overall demand from our global industrial customer base and content growth in diversified applications. Most of our customers have seen an uptick in demand over the past few quarters, and many of the economic indicators, which drive their businesses, remain solid. As a result, they are increasing their production and creating growth for Sensata.

It is important to note that we are reinvigorating growth within the product families that we acquired from CST as a result of investments we have made into the business over the past 22 months. CST has expanded overall content growth opportunities within the Sensing Solutions portfolio, and this is helping to drive higher overall growth in the business as we execute on these opportunities.

Another highlight within this part of our business is that our industrial sensing business delivered double-digit organic revenue growth in the third quarter. Industrial sensing is expanding the use of sensors in a variety of industrial applications, such as heat and water pumps and HVAC applications.

Finally, our aerospace business delivered mid-single-digit organic revenue growth in the third quarter as its markets remain strong.

Our automotive business declined slightly in Q3, posting an organic revenue decrease of 0.2% in the third quarter, which was in line with our expectations. As a reminder, at the beginning of the year, we forecasted that auto would have a weaker second half of 2017, and the overall global market dynamics are playing out, in total, as we expected. Consistent with our prior guidance provided back in February, we continue to expect global auto production will be flat for the year.

Our China auto business continues to capture content gains and is posting strong organic growth despite more difficult year-over-year comparisons. Europe generated organic revenue growth in the quarter despite facing expected diesel mix headwinds, while our North American auto business declined due to lower production and supply chain inventory reductions.

Sensata often gets correlated with the North American auto market even though it is only 19% of our revenues. It is worth pointing out that in the third quarter of 2017, Sensata posted solid organic revenue growth despite significantly weaker performance in our North American auto business. This speaks to the better balance we have built in the business, in line with our strategy.

We expect to exceed our target for new business wins in 2017. We are winning business as customers add sensor content in areas such as gas engine exhaust, braking systems for electrified vehicles, electronic controls for industrial off-road vehicles and tire pressure sensing systems in China and the HVOR market. Sensata is well-positioned to capitalize on large trends such as electrification, while also continuing to benefit from the ongoing secular needs for safety, efficiency and a cleaner, more connected world.

We continued to deliver strong year-over-year margin improvement in the third quarter. This improvement is reflected on Slide 6. We increased both our adjusted EBIT and adjusted net income margins by 90 basis points compared to the third quarter of 2016. The margin improvement was driven by higher profitability from our acquired businesses and lower integration expenses. Our margin performance is a reflection of how well we are executing our integration initiatives to drive higher profitability. I expect that we will expand our adjusted EBIT margins by approximately 110 basis points for the full year 2017.

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On Slide 7, I list some of the key reasons why Sensata is proposing to re-domicile the company to the U.K. First, we believe that being in the U.K. will enable Sensata to be more flexible and effective with our capital allocation. We recognize the importance of capital allocation in creating shareholder value, and the U.K. will provide more options to effectively deploy capital for shareholders.

Second, the U.K. is a shareholder- and governance-friendly environment.

First -- third, we significantly expanded our presence in the U.K. after the Schrader acquisition, and with this expanded presence, we can gain administrative efficiencies by being domiciled in the U.K.

Finally, we will eliminate the requirement of needing to establish that 50% of our shareholders are U.S. residents in order to qualify with certain tax treaty benefits. Our proposed re-domicile still needs the approval of shareholders as well as the High Court in the U.K. We anticipate that the shareholder meeting will take place in early January, and that, if approved, the re-domicile will become effective near the end of the first quarter of 2018.

Turning to Slide 8. Let me wrap up with a few closing thoughts. Through the first 3 quarters of 2017, Sensata is executing and delivering strong performance and has exceeded the midpoint of our guidance in all 3 quarters. On a year-to-date basis, we have generated 3.6% organic revenue growth, which is a substantial improvement over what we delivered in 2016. Additionally, our businesses outside of auto are growing faster than our end-markets due to content growth, and this is resulting in better top line performance. We are sustaining attractive margin expansion.

On a year-to-date basis, our EBIT -- our adjusted EBIT margins have expanded by 90 basis points, and our full year 2017 guidance assumes approximately 110 basis points of year-over-year EBIT margin expansion. This margin expansion is helping to drive double-digit EPS growth. On a year-to-date basis, we have delivered organic adjusted EPS growth of 11%, and we expect to deliver double-digit EPS growth for the full year. We have delivered on our commitment to strengthen our balance sheet and improve our net leverage ratio.

Finally, we are performing to promise. We are delivering on the guidance we've set out for shareholders, and we are enhancing our ability to continue to create shareholder value in the future by re-domiciling to the U.K. and increasing the flexibility of our capital deployment initiatives.

I'd now like to turn the call over to Paul to review our third quarter results in more detail and to provide financial guidance for the fourth quarter and full year 2017. Paul?

Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

Thank you, Martha. Key highlights for the third quarter, as shown on Slide 9, include: revenue of $819 million in the quarter, an increase of 3.7% from the third quarter of 2016. Of this growth, changes in foreign exchange rates were a slight tailwind on revenue growth.

Organic revenue growth, which excludes the impact of foreign exchange rates, was 3.6% in the quarter. Adjusted EBIT grew by 7.5%, and adjusted EBIT margins increased by 90 basis points compared to the third quarter of 2016. On an organic basis, adjusted EBIT grew by 7.1% in the quarter.

Adjusted net income was $138.8 million or 16.9% of revenue, a margin increase of 90 basis points compared to the third quarter of 2016. And adjusted net income grew 9.2% organically, far outpacing our organic revenue growth of 3.6%.

Adjusted EPS was $0.81 in the quarter, a $0.07 increase from the prior year quarter. Of this increase, $0.01 reflects tailwinds from foreign exchange rates. Excluding the impact of foreign exchange rates, adjusted EPS grew 8.1% organically, primarily due to higher volumes and growing acquisition synergies.

Now I'd like to comment on our 2 business segments. I will start with Performance Sensing on Slide 10. Our Performance Sensing business reported revenues of $603.9 million for the third quarter of 2017, an increase of 3.3% compared to the third quarter of 2016, which includes a tailwind of 0.2% from changes in foreign exchange rates.

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As Martha mentioned earlier, this performance was driven by exceptionally strong results in our HVOR business, which rose nearly 20% organically, and the strong performance of our automotive business in China. Our European automotive business grew organically just over 1% during the quarter, which helped offset a weak North American auto market.

Performance Sensing profit was $162.7 million or 26.9% of revenue. Excluding the effects of foreign exchange rates, Performance Sensing profit, as a percentage of revenue, was 27.1%, up 50 basis points from the year-ago quarter. This improvement from the prior year reflects the benefit of growing acquisition synergies, lower integration spend and operating leverage, partly offset by investments to support accelerating new business wins and to optimize manufacturing operations.

As shown on Slide 11, Sensing Solutions reported revenues of $215.1 million in the third quarter of 2017, up 4.9% from the prior year. Sensing Solutions reported organic revenue growth of 5.2%, reflecting continued positive momentum in our served end-markets as well as strong content growth within our industrial sensing business unit. Year-to-date 2017, Sensing Solutions posted 4.6% organic revenue growth, well above its performance from last year. This growth was broad based across the Sensing Solutions portfolio and was particularly strong in China.

Sensing Solutions profit was $72.4 million, an increase of 7.5% from the same quarter last year. Excluding foreign exchange rates, Sensing Solutions profit as a percentage of revenue was 33.9%, a 110 basis point increase year-over-year due to the benefits of growing acquisition synergies, lower integration spend and operating leverage, partly offset by investments to optimize manufacturing operations.

Corporate and other costs not included in segment operating income were $53.4 million in the third quarter of 2017, up approximately $5 million year-over-year due primarily to higher compensation costs and the expenses incurred related to the proposed transaction to re-domicile to the U.K.

Slide 12 shows Sensata's third quarter 2017 non-GAAP results. Gross profit margins declined slightly, primarily due to the expenses incurred to improve the efficiency of our manufacturing operations. Additionally, unfavorable movements in foreign exchange rates caused a slight margin headwind.

The higher R&D spending this quarter reflects increased design and development effort to support accelerating new business wins. Tight control of SG&A expense and lower integration spend both helped to expand our adjusted EBIT margin when compared to the prior year quarter.

Our higher tax rate of 50 basis points in the third quarter is in line with the increase we are expecting for the full year and primarily driven by the jurisdictional mix of profits. On the bottom line, adjusted net income margins improved by 90 basis points, and adjusted EPS increased by 9.5%.

Sensata continues to deliver on our commitment to strengthen our balance sheet. Slide 13 shows that since the start of 2016, our net debt position has declined by approximately $616 million, and our net leverage ratio has declined from 4.6x at the start of 2016 to 3.3x as of the end of Q3 2017. Further improvement of our net leverage in 2017 will most likely be driven by increasing cash balances rather than a significant reduction of debt. And we are on track to reduce our net leverage to approximately 3x by the end of 2017.

On Slide 14, I show our financial guidance for the fourth quarter of 2017. We expect to report revenues between $808 million and $832 million, representing a range of a 2% to 6% revenue growth. At the midpoint of our guidance, we expect that foreign exchange rates will increase revenue by approximately $12 million or 1.5% in the fourth quarter of 2017. Excluding the effect of foreign exchange rate differences, we expect to report organic revenue growth of 2% to 3% in the fourth quarter of 2017.

Our current fill rate is approximately 87% of the revenue guidance midpoint for the fourth quarter of 2017. We expect to report adjusted EBIT between $195 million and $201 million, which would represent organic growth of 7% to 11%.

On the bottom line, we expect to report adjusted net income between $142 million and $149 million and adjusted EPS between $0.82 and $0.86, which would represent organic growth of 7% to 12%. Changes in foreign exchange rates are expected to increase adjusted EPS by approximately $0.01 to $0.02.

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Now let me turn to our guidance for the full year 2017, shown on Slide 15. Given our strong results for the first 3 quarters of 2017, we are raising our guidance for revenue growth. We are now forecasting revenues to be in the range of $3.274 billion to $3.298 billion for the full year 2017, which would represent 2% to 3% reported revenue growth. We expect foreign exchange rates to reduce our revenues by approximately $22 million year-over-year, which is $10 million less than what we guided last quarter. The effect of foreign exchange rates on adjusted EPS remains unchanged as we continue to expect a $0.02 to $0.03 EPS headwind year-over-year. Excluding the impact of foreign exchange rates, we now expect organic revenue growth of 3% to 4% in 2017, up from our previous guidance of 2% to 3%. We expect to generate between $3.14 and $3.18 in adjusted EPS for the full year 2017, which would represent organic growth of 10% to 11%.

We expect that we'll generate approximately $400 million to $425 million of free cash flow in 2017, down from our previous guidance of $425 million to $450 million. The primary driver for the lower free cash flow is related to higher inventory as we transition manufacturing of acquired businesses to new, more efficient locations. We expect that we will see the cash flow benefit from these transitions in 2018.

I will conclude my remarks with Sensata's investment summary on Slide 16. Sensata is focused on delivering profitability improvements to drive double-digit organic earnings per share growth. We expect to sustain our industry-leading high profitability, while increasing the margins of businesses we acquire. We have leading and expanding positions in markets with attractive long-term growth opportunities. And finally, Sensata is a high cash generation business. We are focused on sustaining this strong cash flow generation and deploying capital appropriately to create long-term value for our shareholders.

Now I'd like to turn the call over to Joshua.

Joshua S. Young - *Sensata Technologies Holding N.V. - VP of IR*

Thank you. Carrie, please assemble the Q&A roster.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question will come from Samik Chatterjee of JPMorgan.

Samik Chatterjee - *JP Morgan Chase & Co, Research Division - Analyst*

The first question I had was you had really strong growth rates in both the HVOR and in Sensing Solutions this quarter. How should I really think about the sustainability of that growth going forward? What are you sort of expecting in terms of growth in those 2 end markets in 4Q, for example? And if you can sort of also add color about what the content growth was in HVOR versus what was the industry growth in your estimate in this quarter.

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

If you look at the HVOR market, we believe the market actually moved about 5%, and we moved way beyond that, about 20%. We would expect to have strong content growth on an ongoing basis in our Heavy Vehicle and off-road business. I would say that this quarter was particularly strong. If you think about the way our content growth plays out, it's usually design-in associated with new models and new controls that go into cabs. It's not terribly linear. But over this past year, we've seen high single-digit content growth, and we think that, that continues to be achievable. On the area of the strongest growth within our Sensing Solutions has been in our industrial solutions business, our industrial sensing business. That represents about 7.5% of overall Sensata's revenue, and that's growing similarly from a content perspective as HVOR. The balance of what makes up Sensing Solutions is moving with market. We're gaining share in China, for example, and would expect to continue to sustain that performance

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as well. So those are some of the puts and takes. It will be important to understand how end markets are moving. I think that's a call that we'll want to make as we end this year and look at our backlog into 2018. And that will be part of our outlook for the overall organic growth.

Samik Chatterjee - *JP Morgan Chase & Co, Research Division - Analyst*

Got it, got it. Great. And that leads me to my second question in terms of the industrial sensing business, which you mentioned is 7.5% of revenue but is reporting double-digit growth. I just wanted to better understand. Is it sort of the market overall for industrial sensing is growing at that pace? Or is it more that Sensata's gaining share because there are only a few suppliers that can -- that have access to this technology at this point?

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

So it's a combination. We're seeing some end-markets that are growing, but it's primarily content drive. It's very diversified set of applications. And as our customers look to make use of more efficient solutions, information now that they want to put into an analytics layer, we are seeing nice pull-through on that business.

Operator

The next question will come from Wamsi Mohan of Bank of America Merrill Lynch.

Wamsi Mohan - *BofA Merrill Lynch, Research Division - Director*

Yes. Martha, given your decision here to potentially re-domicile to the U.K., can you comment on a couple of items here? One, how concerned are you about the uncertainty associated with Brexit and cross-border agreements and talent and things like that? And second, when you say more balanced capital deployment, does it mean that we'll start to see a more meaningful uptick in share repurchases in 2018, given the more favorable setup there? And I have a follow-up for Paul.

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

So I think the first thing to note is that this requires shareholder approval and approval by the High Court in the U.K. And so we really need to get through that overall process. The other thing I would share with you is this is a project that required a lot of analysis and many, many, many months of work to ensure that we looked at all of the risks associated. And one of those we looked at was Brexit. Our point of view is when you look at the puts and takes on that, it's primarily related to the trading of goods and services, and you don't see risks associated with tax jurisdictions and being domiciled in the U.K. So I would say that's the major way to think about our position in the U.K. We think it's really important to have balance and optionality in the way that we allocate capital, and the way we think about that is we look at the returns that can come from interesting things that are in our M&A pipeline, and we compare those against the returns that we can provide shareholders through cash returns, and that's a balanced perspective that we have -- intend to take us we go forward. It sounds like you had a question.

Wamsi Mohan - *BofA Merrill Lynch, Research Division - Director*

Yes, my question for Paul is the free cash flow performance, year-on-year, has been somewhat weaker despite these improvements in adjusted EBIT margin. Then -- and you called out inventory earlier in your prepared remarks, has that inventory build been higher than what you thought last quarter? And if yes, what drove that higher level? Was it like better demand? And how much do you think the cash conversion cycle could change in 2018?

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Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

So Wamsi, so this year, underlying the cash flow, we had a significant amount of restructuring spend that we had to fund, charge that we took in prior year, those payments are due, in terms of [severance] and things of that nature. Inventory is higher. But we think it's very prudent to have that level of inventory to ensure that we're going to serve our customers exceptionally well as we transition manufacturing from the sites that are -- we're shutting down, to the new sites which are receiving those new production lines. So we think it's a very smart thing to do. It's a timing issue. We'll get the benefit of the cash flow next year as we convert that inventory into revenue.

Operator

Our next question comes from Amit Daryanani of RBC Capital.

Amit Jawaharlaz Daryanani - *RBC Capital Markets, LLC, Research Division - Analyst*

I guess, maybe to start off with Martha, China has been a nice source of strength for you guys across, I think, both Performance Sensing and Sensing Solutions buckets. Could you just talk about the sustainability of the strength you're seeing in China in those 2 markets, especially in China auto production, as the compares start to get rather difficult entering 2018 for you guys.

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

Sure. So recognize China is now about 14% of our overall revenues, and that's fairly split between auto and our business -- our industrial-based businesses. The end market there has been, I would say, not as strong as past years, a little stronger than we expected here in the second half of the year. So that growth is, particularly on the auto side, is coming from content growth. When we look at what makes that up, and we look at the great success we've had this year in overall design wins, much of that occurring to China, we do expect to be able to extend that content performance as we go forward.

Amit Jawaharlaz Daryanani - *RBC Capital Markets, LLC, Research Division - Analyst*

Fair enough. And then, I guess, Paul, could you just remind us how much restructuring or integration charges that are still ahead for you guys as we think about calendar '18? How much of that should we model in going forward, I guess?

Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

There's probably another $5 million to $10 million to fund over the next 12 months. You can see we've already funded $20 million, and that's in this year's cash flow. So it starts to go down over time.

Operator

The next question comes from Shawn Harrison of Longbow Research.

Shawn Matthew Harrison - *Longbow Research LLC - Senior Research Analyst*

Just if I may touch on North America a bit briefly. Within the guidance, is there any expected, I guess, I don't know if inventory replenishment or whatever the hurricanes may have impacted it, both positively and negatively, into the fourth quarter guidance? Or do you expect, I guess, North America to weaken any further into the end of the year?

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Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

At this point, when we're calling the quarter, we're really looking at our overall backlog, and that's the primary thing that informs our guide. And so you can parse that out and look at how that pertains to overall production rates, and there are some give and takes. There's probably some production that's related to inventory that came out. But quite frankly, that's not the information that we use to guide the forward-looking quarter.

Shawn Matthew Harrison - *Longbow Research LLC - Senior Research Analyst*

Okay. And so within that, nothing related to the hurricanes either?

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

I couldn't say. And so what we're based on is the pull rates and the demand that our customer is providing us. And I'm -- so you'd really have to look at the OEMs' comments on that to understand how much of that is hurricane-based or how much of that is overall demand based.

Shawn Matthew Harrison - *Longbow Research LLC - Senior Research Analyst*

Okay. And a follow-up for Paul, if I may. The euro's rallied a bit over the past 90 days, over the past 6 months. How should we think about, just standing right now, the benefit, potentially, to sales next year and kind of EPS as well knowing that you have a number of hedges that should roll off and provide maybe a little bit of a tailwind?

Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

So for next year we do see a tailwind on the top line, probably in the range of 1% or so in terms of top line. I would say, in the bottom line, which is more important, and you have to take into account we have lots of different currencies that are moving against each other. We think it's probably a $0.07 to $0.10 benefit next year. We still have to finish our hedging program out for the year, rates will move around, obviously, in the fourth quarter. So we'll be able to provide a better view when we give formal guidance for '18, but it is definitely looking favorable in the $0.07 to $0.10 range for next year.

Operator

(Operator Instructions) The next question comes from Christopher Glynn of Oppenheimer.

Christopher D. Glynn - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

I have a question on Sensing Solutions and some of the legacy controls and protection. Wondering if you're seeing any new dynamics work into the long-term growth outlook, just like around broad electronics content of GDP. Any new breadth of uptake for the products you're identifying?

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

That business is remarkable in its ability to find new applications. And as you know, Chris, it's -- those applications are quite niche-y. But we have been able to achieve design-in into that legacy side of the business and also to gain share. Again, a lot of focus in China on that growth. As I mentioned, about half of our content and our growth in China is outside of auto. And the Sensing Solutions, that portion of the business you're referring to, is definitely a piece of that. So it's probably less growthful than other components of our business, but we think it will be able to sustain slightly above GDP growth as we look ahead.

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Christopher D. Glynn - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Okay. And just a question on the margins for Performance Sensing. I think they usually progress upward a little bit in the third quarter versus the second quarter, not so in this instance. Just curious if there's any thought around that.

Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

If you look at the P&L, you'll see R&D costs increased sequentially. And most of that R&D is in the Performance Sensing segment, and most of that spend was to support the accelerating NBO pipeline that we're seeing.

Operator

The next question comes from Craig Hettenbach of Morgan Stanley.

Craig Matthew Hettenbach - *Morgan Stanley, Research Division - VP*

Yes. Martha, I had a follow-up question on CST, your comments around kind of reinvestment in that business. Can you give any context in terms of time line? In other words, in the last 6 to 12 months if you are increasing investment, when that would -- when you would see revenue contribution from those efforts?

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

Yes. Craig, I think, the point we're trying to make here is we're seeing revenue increase now. So if you look at the growth in Sensing Solutions and recognizing that most of the CST portfolio went into Sensing Solutions, it's definitely a driver in the growth of the overall business, and that's coming a little bit sooner than we would have expected. So already seeing the benefits of the investment we did to reinvigorate the growth.

Craig Matthew Hettenbach - *Morgan Stanley, Research Division - VP*

Got it. And then as my follow-up, your comments around capital allocation in terms of flexibility. Any thoughts as the balance sheet leverage has come down in terms of your approach to M&A versus buybacks?

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

I think, again, the way we think about that, we've been able to deliver very high returns with very accretive M&A, and that will continue to be an important part of our capital allocation. We have also in the past returned cash to shareholders in the form of buybacks. So when we think about that going forward, we want to be able to continuously compare those 2 options against each other and make sure that we are selecting what will deliver the best returns for our shareholders. As a result, I would expect to see more balance in our capital allocation.

Operator

The next question comes from Joe Giordano of Cowen.

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Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

I just wanted to dive maybe a little bit more on the wins you mentioned in brake systems and gas filtration systems. Are you predominantly displacing people on those? Or are these new systems that have like never been on certain platforms before?

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

Almost always, the way we gain share is to get into applications early on and grow with them as they grow. So that allows us to outpace the end market, and both of these are great examples of doing just exactly that.

Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

Are you -- on the brake side, I know there's been talk about like putting sensors on the actual pads. Are you guys involved in stuff there? Or is this more on like the larger systems? I know that's something that, as you get more into EVs, some of the manufacturers there are kind of thinking about.

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

Yes. Look, we're always very sensitive to talk about very new sort of emerging applications and new technologies that we're bringing into that kind of an application, so I would probably leave it to the OEMs to discuss what they're doing there. But we're highly engaged in that application and many other subsystems on the vehicle that have to become much more efficient to help to extend the range of things like plug-in electric vehicles and fully electric vehicles, quite engaged on that front. And also systems that need to have more diagnostics as we get into higher levels of autonomous vehicles. So a lot of work underway in that area.

Joseph Craig Giordano - *Cowen and Company, LLC, Research Division - MD and Senior Analyst*

And maybe last, just for Paul. I think you guys currently -- you do not pay cash tax in the U.S. and don't have the expectation of doing so anytime soon. Does anything with your move potentially to the U.K. or anything you've heard out of the federal government here in terms of heating up on tax reform, does that change your outlook there at all?

Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

No, no. The move doesn't affect our cash taxes. The U.K. entity that's moving is the parent company. All the operations remain in the jurisdictions that they are today. So it doesn't have an effect on our taxable income base. And you're right, we won't be a tax payer in the U.S. for a significant period of time.

Operator

The next question comes from Brian Johnson of Barclays.

Brian Arthur Johnson - *Barclays PLC, Research Division - MD & Senior Equity Analyst*

Yes. Could you maybe talk us through on an incremental margin or margin basis, whatever you can talk about, the CPV and margin differences between light vehicle and HVOR? With HVOR having a strong result, automotive flat, is it fair to assume the margin expansion came from HVOR? And how should we think about the incrementals within the segment?

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Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

So no huge differences on the profitability across those 2 business. Most of our margin expansion is coming from the fact that we are improving the profitability of our acquired businesses. And primarily, that focuses on the Schrader acquisition and the CST acquired portfolio. So with the integration spend that we've had and the optimization of our supply chain, we are getting -- we are delivering on the plans that we put in place when we acquired these businesses to bring them to Sensata's margin.

Brian Arthur Johnson - *Barclays PLC, Research Division - MD & Senior Equity Analyst*

Okay. And second of all, can you -- is the higher R&D that you mentioned due to design wins, is that expected to continue through the close of the year and into next year? And how should we think about it for next year?

Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

Certainly, it will continue to be higher for the remainder of the year.

Operator

The next question comes from William Stein of SunTrust.

William Shalom Stein - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

Great. Revenue is clearly outperforming. EPS isn't entirely, in particular, for the out quarter guidance. Does that relate to the R&D comment that you've made a couple times, Paul? Or is there something else? I think, relative to our model, the gross margins appeared to perhaps be a little bit lighter despite great results overall. That was one concern we had, and we'd love to hear you explain it.

Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

So this quarter, I mentioned that we did spend some money to continue to optimize our manufacturing operations in both Performance Sensing and Sensing Solutions, and that will drive efficiencies in the future. For the fourth quarter, the big increase, I would say, relative to what you would expect, is the higher R&D spend to support this accelerating NBO pipeline that we have to fund to launch those products in the future. FX was also a little bit of a headwind this quarter in the third quarter as it relates to our cash flow hedging. So it was about a 15, 20 basis point headwind.

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

To gross margin.

Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

To gross margin. You can see the offset down below in other income and expense. I think gross margin was a headwind.

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William Shalom Stein - *SunTrust Robinson Humphrey, Inc., Research Division - MD*

That's helpful. Maybe one other, if I can. Paul, I think, at least a couple of times you've talked about your expectation for growth in 2018, while you're not -- clearly not guiding it now, to exceed the growth that you're seeing in 2017. And perhaps the R&D that you're doing now is a sign that you're supporting that and you still expect that. But any comment around that and the margin trajectory for next year would also be really helpful.

Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

So the design work that we do today typically results in revenue over the next 3 to 8 years so what we're doing today won't have a big impact on '18 per se. There is maybe a little bit, but most of that's longer term. So I think it's the right investment at the right time, given the acceleration of the NBO pipeline.

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

Yes. So we're on a strong cadence, an improved cadence of organic growth, and you're seeing that play out in 2017. Frankly, stronger than we had called it coming into the year when we had also said at that point in time we expected 2018 to be stronger than 2017. So we're feeling good about a continued cadence of strong organic revenue growth.

Operator

The next question will come from Mark Delaney of Goldman Sachs.

Mark Trevor Delaney - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Yes. First question I wanted to follow up on the trends that Sensata is seeing in electric vehicles. I think the company said over the summer that average content on a pure electric vehicle is in the mid-$20 range per car versus something in the mid-$30 range on a traditional combustion engine. But also, that Sensata has been working to close that gap. Could you just update us on where you stand with those efforts and -- on an organic basis? And is that something that Sensata would look to address inorganically?

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

So we're making great progress in terms of adding content to all manner of electrified vehicles. In the near term, we're seeing nice take rates on braking systems that regenerate energy, for example. Those are relevant on both hybrid, plug-in electric and fully electric vehicles. One of the things that we're seeing is quite a range in the content that's available on electric vehicles as some of the more sophisticated manufacturers are moving into their gen 2 and gen 3 versions of a fully electric vehicle, and we're seeing our content opportunity come up significantly as that happens. So quite engaged in that. We're at the point now where if you try to use an average number on a pure electric vehicle for Sensata, so meaning, no plug-in, pure electric vehicle, there is such a range based on the model and where it's built in the world that the overall average is not all that meaningful. So it can be well above the content we see on a typical gas engine vehicle or below, depending a lot on who the OEM is, where in the world that product is being made and whether or not it's a gen 1, gen 2 type of vehicle.

Mark Trevor Delaney - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

That's helpful, Martha. And a follow-up question also on longer-term trend. I think Sensata said earlier in the year that its expectation for diesel penetration rates in Europe was that it would go from about 48% earlier in calendar '17 to, I think, it was 43% was the forecast by 2022. Is there any change in the company's expectation for diesel penetration rates?

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Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

We're watching that one really closely. And as a reminder, what we keep our eye on is overall production of diesel engines in Europe, some of those being exported outside of Europe. In this past quarter, for example, we saw a 1% decline in the diesel engine production in Europe, so that was a headwind for us. And so as we look ahead, we're being very mindful of what can change that and is it changing, and we'll continue to share that perspective with you as you go forward. Some of the puts and takes on that, I think, as everybody knows, the take rates, the sell rate in Europe is coming down. Interestingly, we're seeing stronger demand for things like light commercial vehicle diesel content in emerging market, and that's a bit of an offset to the European headwind.

Operator

The next question comes from Jim Suva of Citi.

Jim Suva - *Citigroup Inc, Research Division - Director*

I have one question for Martha and one question for Paul. Martha, can you talk a little bit about inventory levels, whether it be at the distributors or the channel? Specifically, more in your HVOR and your industrial segment, is it below average? In line with average? Above average? Just any thoughts on inventory in the channel. And then the question for Paul is, Paul, if I heard correctly, given your hedging, it sounds like about a 1% top line benefit for next year and $0.07 to $0.10 of earnings benefit next year. Can you confirm if I got those right? And then also, just explain the methodology you guys use for hedging. Is it like a 3-year hedge, 1/3, 1/3, 1/3 and you keep putting them on as they roll off? Or has anything changed, just so we can think about, long term, your hedging programs?

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

Sure, Jim. So as it relates to inventory in those end markets, it's, I would say, overall in line, maybe slightly lower in portions of our Heavy Vehicle and off-road business. So we don't get a ton of visibility to dealer inventory there, but it is a channel check that we do. So slightly lower in that part of the business, in line with the other areas of our industrial business. And keep in mind, Sensata does not have a lot of revenue that runs through distribution. So we'll be more line-to-line with overall demand than other firms as a result of our overall channel strategy.

Paul S. Vasington - *Sensata Technologies Holding N.V. - CFO, CAO and EVP*

And Jim, as it relates to foreign exchange, it is an early view, but I did say 1% higher revenue next year due to more favorable foreign exchange rates and then $0.07 to $0.10 of incremental EPS due to favorable foreign exchange rates. Our hedging program is to hedge, on a rolling basis, over a 18- to 24-month period, and we layer those hedges in over time. And so we -- doing that, we try to create a reduction in earnings volatility over time due to movements in exchange rates.

Operator

The next question will come from Rich Kwas of Wells Fargo Securities.

Deepa Bhargavi Narasimhapuram Raghavan - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

This is Deepa Raghavan for Rich Kwas. Your HVOR organic growth, pretty strong, obviously, as questions are asked about it, too. In the past, I thought you mentioned it was a richer mix. Just curious, should we expect that to use 2018 conversion rates, assuming it's a richer mix? Or has something changed within your HVOR products? Or anything that we should be thinking about as offsets to what would -- you'd have thought was a richer mix in the past?

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Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

Yes, we always -- I think 9 times out of 10, folks assume it's a richer mix. Our overall margins are really strong across the business. And when you look at the way we manage our overall operations, it's a part of how we drive the business. So this is not a change from prior. We have strong profitability, both in our automotive business and our Heavy Vehicle and off-road business.

Deepa Bhargavi Narasimhapuram Raghavan - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Great. You did call out 1% diesel -- lower diesel or a diesel decline in Europe production -- in Europe diesel production. Curious, if you would be able to quantify how much that possibly clipped your automotive revenue growth? I don't know if you qualify it. But if you can, that will be helpful. And wondering if you saw -- if there's any evidence that you've seen that the headwinds actually accelerate. You did give us your outlooks going forward, but are you seeing that accelerate? You pointed out sales being lower, production needs to catch up at some point in time. So just curious if you've seen that accelerate.

Martha N. Sullivan - *Sensata Technologies Holding N.V. - CEO, President and Executive Director*

No. Just a couple of data points. On an annualized basis, about 1% decline is about $5 million in revenue for Sensata. So 1% decline on diesel, $5 million in revenue on an annualized basis, if that's helpful. I think another data point is if you look back, let's say, 5 years, we've seen about a 10% overall reduction in that mix on diesel. So it's been a cadence downward. Some acceleration on that, if we look in 2017, but not beyond what our expectation has been. And so the other thing to think about is, with a 1% decline today equals $5 million in revenue, that gets smaller as we move forward for 2 reasons. Some of those diesel engine vehicles are actually moving to a hybrid vehicle. And when that happens, we're getting to a point where the difference is quite small. And at the same time, our gas engine content in Europe is coming up. And that's been on a cadence of improvement in '17, it will improve even further in '18 and into '19. So in the time period where we think we're going to see the most deceleration of diesel, we're getting to a point where the gap between our content on a diesel engine versus a gas engine versus a hybridized vehicle is becoming negligible.

Operator

And that's all the time allotted for today's call. I would now like to turn the conference back over to Joshua Young, Vice President of Investor Relations, for any closing remarks.

Joshua S. Young - *Sensata Technologies Holding N.V. - VP of IR*

I'd like to thank everybody for joining us this morning. We appreciate your continued interest in Sensata, and we look forward to hosting many of you at our upcoming Investor/Analyst Day in New York City on December 12. If you'd like to attend this event, details about the event and registration are posted on our Investor Relations website. Thank you, and good day.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect your lines. Have a great day.

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