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EDITED TRANSCRIPT

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Zhen Yang *Citigroup Inc., Research Division - VP*

PRESENTATION

Zhen Yang - *Citigroup Inc., Research Division - VP*

Good morning, everyone. Thanks for joining Citi's virtual tech conference today. My name is Tim Yang, and I cover tech dispute sector at Citi. I also support senior analyst, Jim Suva, on tech supply chain coverage.

For this session, we're pleased to have Sensata's CEO, Jeff Cote, and the VP of Finance, Jacob Sayer, joining us to share their insights about Sensata and the industry.

As a quick background, Sensata is the largest independent automotive sensor company globally with business in America, EMEA and Asia.

A few housekeeping items for Citi -- from Citi, Research side. There are disclosures associated with this for you to review. All clients subject to MiFID II are reminded that they need to have research agreements in place and contact your city salesperson, if you have any questions. With that, I would like to hand over to Jacob for a quick overview of Sensata. Jacob?

Jacob A. Sayer - *Sensata Technologies Holding plc - VP of Finance & CFO of Performance Sensing Gbu*

So let me bring the slides up. Thanks, Tim. I think we'd just like to -- for those folks that are new to Sensata on the call run through a little bit of background on Sensata itself.

Jeff?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Great. Thanks, Jacob, and thank you, Tim, for the introduction, and thanks to all of you for joining the call and for your interest in the company. If you want to hit the next slide quickly, Jacob.

Sensata, as Tim had mentioned, is a 100-year-old industrial technology company. We certainly serve the automotive market, but we serve a number of other end markets as well.

And although you may not know the name Sensata, I'm sure you use our products every day in your homes and your places of work and your modes of transportation.

In 2019, we had revenue of about $3.5 billion. We employ a little over 21,000 people globally at the end of 2019, and we operate in 11 countries. So certainly a global company.

On next page, please, Jacob. We have a very strong legacy of designing and manufacturing, hard to do mission-critical sensors and electrical protection that help our customers solve their most difficult challenges as they define their product road maps and their plans to serve their end customers.

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And these products that we produce need to function in the harshest environments. Many instances, they're embedded in hydraulic or oil -- hydraulic fluid or oil and are subject to extreme temperatures. So their -- the packaging requirements associated with our products is quite high.

More and more, our customers are asking us to extend beyond just sensor components into subsystems, software and other applications and capabilities that deliver valuable insight to them in terms of what's going on in the environment that they need to understand in order to make their equipment work.

We focus on very high value, high growth segments, and we have a proven low-cost and very variable cost structure.

And not only a cost structure but a management intent to run the business with low-cost and in variable nature, which has obviously served us quite well in a year where we've seen a pretty significant major market dislocation.

We have a long history of continuous improvement as well that allows us to continue to generate very strong differentiated margins in our core business, but also in the businesses that we acquire, the cost synergy as well as the revenue synergy of the businesses that we acquire tend to be pretty significant. We're not capital intensive. Our CapEx as a percent of revenue is about 4%. And therefore, we're able to convert a lot of those differentiated margins into cash, 85% or better is converted into cash. And that provides flexibility for us in terms of creating more value for shareholders, in terms of flexible capital deployment.

Historically, we focused on M&A and share buybacks as our primary areas of capital deployment.

Next page, please, Jacob. We serve a number of OEMs and tiers and aftermarket customers. As Tim mentioned in automotive, for sure, about 50% of our business is automotive, but also heavy vehicle off-road, agricultural equipment, construction equipment, recreational vehicles and aerospace, both commercial and defense as well as a number of industrial markets, such as smart buildings, factories, clean energy and other diversified industrials.

This slide shows that there are a number of applications that we serve in these end markets. And the key point here is that there's no one application or no one regulation that represents a significant portion of revenue concentration for us or is a growth driver for us.

So there are hundreds of applications, hundreds of regulations that are being implemented across end markets, across the geographies that we serve that provide that growth opportunity, not only market growth, but content growth.

Next page, please. We benefit as a company from a number of mega trends, such as the need for more clean and efficient systems, mega trends associated with the trend associated with electrification, Smart & Connected or Internet of Things, IoT related applications and also autonomy.

And these trends drive the need for more of what we do, which enables us to have long-term secular growth as well as cyclical growth in our business.

We refer to that as outgrowth to the markets that we serve. And we've demonstrated this secular growth consistently over the past several years, given the -- and given the long cycle nature of our business and the new business opportunities that we have secured, which have been over $400 million on average over the last 3 years. It gives us a high level of confidence in that continued outgrowth. We tend to focus on our automotive market having somewhere between 400 and 600 basis points of outgrowth in our HVOR market, having somewhere between 600 and 800 basis points of outgrowth to the end markets themselves.

Next page, please. Diving into the megatrend area in a little bit more detail, we continue to believe that investments with our customers in electrification, Smart & Connected and autonomous features will continue to be made by our customers and will allow us to continue to increase our end market diversification, increase our long-term growth rate and provide a very important competitive advantage to us as these trends transform the world we live in and the end markets that we serve.

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Despite the impact of COVID-19, our customers are continuing to make investments in these areas in a pretty aggressive way. They understand that these megatrends will be impacting their businesses more in the next 10 years and they've seen in terms of changing their business over the last 50. So they're continuing to make investments, and we're continuing to make investments alongside them to allow us to be able to serve them.

In electrification, we are expanding the solutions to provide critical applications across all of the end markets we serve. So it's not just a play in automotive. It's in all of the end markets that we serve. And in the second quarter of this year, we closed another $50 million worth of new business, specifically in the electrification megatrend. And that brings us through halfway through the year at over $108 million of new business wins associated with electrification across the end markets that we serve.

And as the electrification trends continue to accelerate, really driven in part based upon very broad legislation, such as the European green new deal. They offer increasing opportunities for us to bring our solutions to market, and it represents over a $6 billion addressable market for Sensata by 2030.

In the area of Smart & Connected, we continue to test proof of concepts with leading fleet managers. We've sold some Smart & Connected elements of our offering to our OEM customers, but we continue to do proof of concepts with leading fleet managers, and we're expecting to be able to convert these to orders by the end of the year.

And we're also collaborating with telematics companies that will allow us to transmit data collected by Sensata sensors and the Sensata vehicle area network to the cloud to provide very valuable insight to these fleet managers. And we're proving that out with 5 very specific proof of concepts with large fleet managers of North America.

This opens up another very large market. It's about $1 billion market in the OEM space, but it's a $7 billion addressable market for us by 2030 in the fleet area.

So we're investing in these very high-growth segments that need our expertise to be able to allow them to run more safely and more efficiently.

And more recently, to build on our foundation of autonomy, we acquired PRECO Electronics. You might have noted that from our second quarter call.

PRECO is a leader in radar solutions and object detection for critical safety applications, such as blind spot detection or side turn assist for heavy vehicle on-road and off-road markets.

This is a very sticky mission-critical technology that reduces collisions, vehicle downtime and improves operational safety in a variety of markets.

This brings to us about a $600 million addressable market by 2030. PRECO is a very small business today, but very promising opportunity in terms of growth, again, driven by -- in part by legislation, such as the EU Vulnerable Road User regulations, which are required to be implemented, I think, by the end of 2021 or early 2022.

In terms of some key takeaways. I believe we're very well positioned to navigate not only the near-term but the long term. And it's really -- thanks to our core operating discipline, we have a strong balance sheet as a company. We have cash of over $1.5 billion available to us on hand after the closing of our more recent $750 million bond deal and the repayment of our revolver of $400 million that we drew back in, I think, early April of this year just out of an abundance of caution to make sure that we had very significant cash flow available to us.

We've aligned our cost structure to the new market realities. We did that through temporary measures in the second quarter, but we've implemented permanent measures to get our cost structure aligned as we begin 2021. Those restructuring activities will take a couple of quarters to take effect, but we're confident in that $60 million to $65 million of annualized cost savings to be implemented by -- in a full annualized basis by the first quarter of next year.

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And we're producing very strong new business wins regardless of the market environment that we're living in. And those NBOs continue to come in, which gives us continued confidence about the long-term outgrowth of the business.

We have a number of innovative technology solutions to address very large market opportunities. I've touched on some of them. We believe there is a market opportunity by 2030 associated with electrification of over $6 billion, about $6.5 billion in the Smart & Connected area, both fleet and OEM of about $8 billion, a growing opportunity in autonomy of $600 million. And that's not even to mention the trend associated with Clean & Efficient, which has been the primary driver of our growth for the last couple of decades, which is about a $20 million, $21 billion market opportunity in 2030.

So big market SAM to go address, and we continue to build capabilities to be able to serve those markets. Finally, before we go to Q&A, I just wanted to mention, we did do a press release last evening, raising our financial guidance for the third quarter of 2020 to a range of $735 million to $765 million and operating income of $132 million to $142 million.

That's largely driven by greater-than-expected demand from our automotive customers in North America and Europe.

We did, as we gave original third quarter guidance, note that we had fill higher than we thought was ultimately going to materialize. And fortunately, those orders did materialize through July and August, and it now gives us more confidence to be able to update our guidance to that $750 million midpoint range for the third quarter.

In summary, I think that we're very pleased with how our organization has responded in very challenging environments. And we continue to demonstrate our core capabilities and advantages in the markets that we serve and have confidence in our long-term growth prospects. With that, Tim, I'll go back to you and we can take questions.

QUESTIONS AND ANSWERS

Zhen Yang - *Citigroup Inc., Research Division - VP*

Great. Let's dive into the Q&A. Jeff, I'm glad that you mentioned updated the Q3 guidance. Can you maybe just walk us through the updated September quarter outlook and then also the sustainability of this demand strategy you are seeing in the end market?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes, absolutely. So as I had mentioned in some of the prepared comments, in our second quarter call, we provided some commentary.

We had a disconnect between what we thought the automotive market was going to produce in the third quarter and what our third-party forecasters, IHS, were forecasting. There's about a 1.7 million unit disconnect.

We talked a lot about that in our call. Second quarter of the year, we saw order rates from our customers that didn't materialize.

So customers placed orders to ensure that the supply chain would be there. And then they had late in quarter dropouts of those orders. And so we were concerned that the fill rate that we are seeing from our customers was not the best indicator of ultimate demand that we would see.

That's turned out to be a positive surprise for us. Those orders have materialized through the first 2 quarters of -- excuse me, the first 2 months of the third quarter.

We've seen the trajectory of those orders convert to shipments to our customers, and we're feeling more confident in the last month given that we're partially way into the last month of the quarter. So we feel pretty good.

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We still candidly do have about a 200,000 unit disconnect in Europe around what IHS would say automotive sales would be and what we would predict but obviously a much narrower gap. And we feel good with the guidance that we provided and feel good also about the drop-through that we're experiencing on that.

It is important to note that this is all automotive. That is our lowest-margin business. And so it's not dropping through as much as we would expect against company overall margins, but it's dropping through nicely relative to the end markets that are increasing.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got it. I think you touched a little bit on the fill rate. So I think when you provided the guidance last quarter, the fill rate was roughly 93%, and then that's higher than 88% a year ago.

And then you build some conservatism in terms of order cancellation for the quarter. So going forward, should we expect that the fill rate, when you provide guidance to 93% is the normal level for you guys, like probably in the next -- in the coming quarters? That's the normalized fill rate or it will drop to 88%?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes. I think it will more normalize. And historically, if you look at the last 10 or 12 quarters, as we've entered the quarter, we tend to have about mid- 80s to high 80s in terms of fill rate relative to our revenue guide.

I would expect that to normalize over time. We're in a very different situation. Obviously, it's going to depend, Tim, on what our customers see in terms of the volatility of their end markets.

But if we continue to see the stability that we've experienced in the third quarter, I would expect that to normalize.

But we'll provide that color. We'll be transparent about what fill rate we see and whether or not we've hedged that back a little bit or if we're allowing the fill rates to be the predictor in terms of what we're forecasting for ultimate demand in our business.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got it. I think you mentioned that in the second quarter, you had some rush orders or double ordering from end customers because they're trying to make sure that they have the components to produce the products.

But can you maybe just share with us your visibility in terms of the inventory level on the customer side? Do you think they still need to digest the inventories in the next 1 quarter or 2 quarters? Or do you think that the inventory digest is pretty much down at this point?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes. So we had spoken about the fact that in the first quarter, we saw about $25 million of inventory build in our customer supply chains, primarily in China automotive.

In the second quarter, that converted to North America and Europe. It came out of China, went into North America and Europe.

So we didn't leave the second quarter with an enormous amount of inventory in the supply chain.

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I would credit that largely to our approach with our customers. When the customers place the orders to ensure that we would be able to deliver for them, and then they dropped out orders, we allowed a lot of those orders to drop out.

And that obviously created operational friction for us in terms of us managing our cost structure. But we felt that was the right thing to do to not fill the supply chain with inventory that would ultimately unwind in a later quarter. It would just make things more opaque and difficult to sort of manage through. $25 million of inventory in the global automotive supply chain, in our view, is an enormous amount of inventory.

We would have expected that to unwind a little bit in the third quarter and then the balance of it unwind in the fourth quarter. Yet to be determined, ultimately where that will land, but I think that's a pretty good expectation. I wouldn't expect customers if we get to more normalized demand patterns, they'll unwind the inventory pretty darn quickly, I would expect. And we'll get more to just-in-time inventory modeling that we've -- they've relied on and we've been able to deliver on in the past.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Can you share with us your view in terms of the global auto production for this year?

I think you had mentioned that you were a little bit conservative in terms of auto production for the third quarter, you were below IHS. But right now, it turns out to be like pretty much in line or consistent with what IHS has just forecasted for Q3.

So what about the fourth quarter? And then maybe going forward, can you maybe just share with us your view on the global auto production?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes, absolutely. So even at these third quarter rates, we're still, I think, 9%, 10% down versus third quarter of last year. The fourth quarter, IHS is forecasting.

And certainly, we would support that it looks like it's going to continue to improve from the third quarter level.

I don't think it's going to be back all the way to the fourth quarter level of last year.

My expectation would be that it's going to take a little bit more time to get back to, if you will, the run rate at 2019.

But certainly the snapback that we've experienced in the third quarter off of a very, very low second quarter is greater than I would have anticipated.

We're remaining very cautious as schools start back up, as employers start to bring people back to work, there is obviously a concern that there will be a resurgence of COVID cases that will -- may cause some continued lockdowns. I'm not predicting that. I'm just being cautious that obvious lockdowns could have an impact on that demand in the fourth quarter. And so we're going to continue to be quite flexible on this, Tim, and manage what's coming at us from ultimate demand from our customers. But certainly, the recovery has looked good. I would anticipate based upon indicators that I'm seeing that, that will continue in the fourth quarter.

But we haven't provided specific fourth quarter guidance yet. But the markets do seem to be trending in a very positive direction, and we'll continue to analyze that and provide an update on our call.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got you. So you increased your revenue outlook by roughly $60 million for the quarter. You mentioned the volume is a big driver for that.

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But how much of that is from the content increase? And then maybe just share with us your content growth outlook for this year or maybe for next year as well?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes. We had a very strong first half on content, higher than what our forecasted averages were for the end markets that we serve.

And we had anticipated based upon product launches that were going to happen in the second half of the year that, that content was going to dissipate a little bit off the first half rate, but for the full year, we're still expecting, call it that midpoint of 500 basis points in auto and 700 basis points in HVOR.

That's still our expectation. That's more driven based upon launch calendars and also some deferral associated with the shutdowns that occurred in the second quarter where customers just weren't quite ready to launch things in the second half given the disruption to time outside of the office and so forth.

But we believe that -- and we're very confident in the fact that, that is a short-term impact. We're very confident that, that content growth will resume as we start to enter 2021 and customers catch up on the work that's necessary to allow them to be able to launch those new platforms that drive the content growth for us.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got it. We actually received a question from investors that, can you maybe just provide some color on content growth opportunities over the next 2 to 3 years? That's more a little bit medium to longer term? And what are some of the applications that are driving the content growth going forward? And how much outgrowth should we expect relative to the end market?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes, absolutely. So content is a long-term story. We are a long-cycle business in terms of our new business wins and our product development life cycle.

So we get a lot of visibility into content. Market cyclicality is harder to predict but content, we know what we've sold.

We know what we're working on from an engineering standpoint. The range for auto is 400 to 600 basis points.

We've achieved that over the last 2 years. We think we can achieve that in 2020. And we're confident based upon new business wins that we've already won over the last 3 years that we'll be able to continue that in automotive going forward.

Same for HVOR, it's a little bit higher. Content is between 600 and 800 basis points. I think it was 735 basis points over the last 2 years.

We would expect it to be in that range for 2020 and for the years going forward. We've sold on average over $400 million of new business win over the last 3 years, which adds to our confidence in terms of how that will trundle through the business in terms of content.

Obviously, some of that will diminish over time, $400 million per year would translate to our higher content growth than what I've quoted.

But we're very confident in the base of business that we've won that will provide for that content growth over the coming years.

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Zhen Yang - *Citigroup Inc., Research Division - VP*

In the past, emission standard was the driver, it was a big driver for Sensata content growth. Any emission standard implementation that would help Sensata's content growth in the next 1 to 2 years?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes. So your point is exactly right. Historically, environmental laws that have been implemented around the world and safety-related regulation that's been implemented around the world have been primary drivers of our content. And in fact, the trend of electrification is an environmental regulation, right? So the need for more efficient vehicles, the need for more environmentally friendly vehicles is driving the trend towards electrification.

Last check, there were over 3,000 environmental laws on the books globally, very broad-based, not just in light vehicle, but more broadly in industrial and other applications as well. So there's not just one. There's not just one safety-related regulation. And each one of those drives product road map activities for our customers, which drives a need for our product. And every OEM approaches it differently.

The point being in that there isn't just one, there are some lumpy ones, things like implementation of tire pressure monitoring.

It's a big application. There's a lot of sensor content in direct tire pressure monitoring. So you tend to see some like that, having a bigger impact on our business, but there are literally hundreds of applications that are being developed in various forms across different OEMs, across different end markets, across different geographies that drive that content growth for us over time.

And we're very good at taking core capability that we have, core technology that we use to bring those solution sets to those customers in a way that's very modular. So we use a building block approach so that as we do a brake pressure sensor, and then we apply that same technology to a TMAP application. We're using different technology, but we're using similar packaging techniques and similar manufacturing lines to allow us to bring it to market at very differentiated margins.

So that's really the sweet spot that we play from a company standpoint.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Great. Can you maybe just talk about your content dollar amount for different types of vehicles and maybe the content growth opportunities in those different end markets?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes, absolutely. So in North America and Europe, our content per vehicle in a combustion engine environment is call it, a $30 range, high $30 range, right?

So in that $35 to $42, depending on the OEM, the application, we're still a little bit higher on diesel applications, but it used to be a much bigger difference between content on diesel and gas than it is today.

There's now only a couple of dollar difference. But in Europe and North America, it's, call it, that high 30s, low 40s.

In China, combustion engines is about $20. So as incremental emissions regulation, as incremental safety-related regulations, we see a line of sight to the $40 per content on a combustion engine. We feel very confident in the fact that there's about a $50 Sensata content per vehicle in a battery electric vehicle.

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And so as that trend evolves from combustion engine to electrified platforms, we feel as though that's going to be a nice tailwind for us as a company.

A lot of work to be done to design product that we've won business already, but we're seeing a very good trend, both with organic activities that we have around e-motor position, battery pressure for managing terminal runaway or high-voltage contactors, just to name a couple of the applications in a battery electric vehicle environment.

So real promise in terms of that transition and the content per vehicle that we'll experience.

Zhen Yang - *Citigroup Inc., Research Division - VP*

So you touched a little bit on EV. So the $50 content for EV that's across the globe, right? That's worldwide, like $50?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

It is. And it's actually -- it tends to be higher on premium vehicles than on the low-end vehicles. So the measure there, if you think of the range and as range goes up, and as charging time comes down, there's going to be more of the Sensata content on those vehicles because there's more energy transferred. And so the criticality of the functionality of our products is higher.

So that's where you tend to see a higher level of content on those premium vehicles. Now we all know everything is moving in that direction over time to get to a longer-range on electric vehicles and shorter charge times to make it more comparable to a combustion engine environment.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Who are you competing with in the EV market? Is that like your traditional competitor like Denso and Bosch? Basically, you compete with them like in diesel and combustions. Is that the same comparisons like in EV side? And also, I have some question on the battery management side, but if you can touch on the competitive landscape in the EV side sensor, that would be great.

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes, absolutely. So competitors vary depending on application, right?

So yes, Bosch, Denso, Continental and Pressure Sensing would be the primary competitors. When you're starting to move into areas like high-voltage contactors, the competitor set is very different.

So in a high-voltage contactor application, the competitor set would be TE Connectivity, Panasonic, Hangfa, out of China, LSIS, out of Korea. So they're different, but they're still a select few. Given the mission-critical nature, there tends to be only 3, 4, 5 competitors that we would see because the street credibility you need to be able to serve these applications. The high-voltage contactor is protecting the most valuable component in the vehicle, the battery, right? So it's making sure that, that charging session is done in a very safe way that doesn't damage the vehicle and doesn't, God forbid, damage the individual applying the charge. So the competitor set does change, but it always tends to be a select few that we work with to sort of manage through that.

It doesn't -- we tend not to see 30, 40 competitors in the application sets that we're serving.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got you. So battery management was actually a key area you highlighted before for commercial vehicles and EV.

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Can you maybe just give us an update on your battery management offerings? And you mentioned that you have something like $50 million wins in the past couple of quarters in that field.

So can you maybe just give an update on the business trend over there and the growth rate that you expect? And then how should we think about the content contribution from those better battery margin -- battery management offerings?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Absolutely, Tim. So the wins that we've experienced in 2020 actually have not been related to battery management. That has -- is still a -- well, actually, let me rephrase that, not related to wireless battery management.

So we have an organic development activity on wireless battery management. Basically, the foundation of that is the wireless capability that we have with tire pressure monitoring that we brought into communication protocol between a battery cell and battery management system to remove the wire harness, to create more space for more densely packed units, but also to allow there to be capturing data at the cell level for second use associated with the battery pack, which is obviously critical.

The abuse that the battery pack suffered will impact the resell value of the battery pack for its second life. So that's the play there, right?

It's allowing for more density. It's easier installation, modularity on wireless. We're in test on that. So there's no business that we've won on wireless.

There are opportunities that we won on a wire battery management. And that's an inorganic play.

We acquired a very small business. We own a minority interest today, but we have a right to buy the balance of the business, a company called Lithium Balance out of Denmark that brings wired battery management capabilities to us.

So that's obviously hardware and software capability to manage that process, extremely promising, early to conclude in terms of the revenue opportunity that we could experience on that, but a battery management system, depending on if it's in a light vehicle or on-road truck environment or in an energy storage application could be $100 of content.

So significantly different. It's not a component, it's a subsystem or a system that we'd be selling.

So a very different ASP associated with battery management as we would normally experience in our business around sensor components.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Great. Let's switch gear to the margins and the cost structure. On OpEx, are you realizing the cost reduction faster than originally expected? And how should we think about further cost reduction for Q4 and Q1 next year?

Jacob A. Sayer - *Sensata Technologies Holding plc - VP of Finance & CFO of Performance Sensing Gbu*

So in the second quarter, Tim, we implemented some short-term cost reductions in order to offset the drop in revenue. That was about $22 million of temporary cost reductions. It also bought us the time to put in place a permanent cost reductions, restructure the organization in order to match demand flows that we expect early next year. We expect that those long-term savings, which are permanent in nature, will generate about $60 million to $65 million in annual savings beginning next year. And we're in the process here in Q3 and Q4 of those ramping up.

So in Q3, we said we expect about $7 million out of that $60 million to $65 million to materialize, and we look to be on track for that during the third quarter. We'll see a step-up in Q4 as more of those cost reductions do have an impact and other step up and Q1 before we get to that normalized run rate of about $15 million to $16 million per quarter.

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We're very much on track with that restructuring activity.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got you. So a quick follow-up on that. So if I calculate your margin outlook, that's probably like 100 basis point higher than original guidance for the operating margins, which is your updated outlook.

But if I compare the flow-through margin between the new guidance versus the old guidance, the flow-through margins is probably like similar at 35%. With the cost saving you just mentioned, should we model or think about flow-through margins would be higher after you realize all those restructuring benefits?

Jacob A. Sayer - *Sensata Technologies Holding plc - VP of Finance & CFO of Performance Sensing Gbu*

Well, given that we're just as a first step of the restructuring, right, the margins will improve as we go. The volume will also help, right, because the volume is going to drop-through, on average, in a mid- to low 40s incremental margin rate.

What you're pointing out there, though, in terms of the change in guidance from the end of July to what we issued last night, the step-up in revenue was all coming in the automotive space, and in particular, in Europe, in North America, automotive space, those markets in that end market has a lower -- it's at the lower end of the stack in terms of margins within Sensata profile with aerospace at the high end and auto at the low end.

So the mid-30 incremental that you mentioned in the change in guidance is right in line with the automotive marketing structure.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got you. So basically, you're saying that with mix is a little bit more favorable and then the volume and better utilization comes back, you should see a little bit better flow-through rate than the 30% to 35% of the flow-through margins.

Jacob A. Sayer - *Sensata Technologies Holding plc - VP of Finance & CFO of Performance Sensing Gbu*

As volumes increase on a more consistent basis across the whole organization rather than in just one spot, yes, then the uplift in margin, the incrementals will be better.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got you. When we think about this pandemic and the supply chain disruptions, how should we think about your variable costs versus fixed costs going forward? Have you adjusted your footprint to be less centralized compared to pre-pandemic level? And then I think you mentioned before that variable cost is probably like 80% to 85% for Sensata's product. So should we think about that similar going forward?

Jacob A. Sayer - *Sensata Technologies Holding plc - VP of Finance & CFO of Performance Sensing Gbu*

So as a percentage of revenue, the variable cost piece of our cost structure is about 50% of revenue. And then we have a semi-variable component, which is about 18%, 19%, and then we have the fixed component, the balance would be EBIT. So it is a highly variable cost structure to begin with.

I don't think that, that will change substantially as we go forward in terms of the footprint.

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We are consolidating a couple of our smaller sites into others, some of the smaller manufacturing sites into others as part of this restructuring program that we've undertaken, but that's not going to substantially change the overall cost structure. So I expect the fixed component will remain in the 8% to 9% range. The variable component will remain in the 50% range or so.

And then the semi-variable piece, which is really big personnel costs, right, and the project costs that we have, that's the main area that we targeted with the restructuring program that we undertook. So that cost structure, that's where we'll see the cost savings. And I expect that would come down as a percentage of revenue as a result of that restructuring activity.

And then we'll look to hold that as low as possible as revenues ramp, hopefully next year.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got you. So you recently completed a small acquisition, Pricol, despite the challenging environment. Can you maybe just talk about your capital deployment strategies going forward?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes. I'd be glad to. So we're in a great position. As I mentioned in the opening comments that we convert a lot of our earnings that are differentiated in terms of margin indexed cash.

So we are a business that generates a lot of cash. Our approach to capital deployment is very balanced toward both M&A, bolt-on M&A to create accretive revenue growth and earnings for the business and also share buyback. We did pause our share buyback program in April of this year, given the volatility that we are seeing in the market and a desire to make sure that we were being very conservative in terms of our capital deployment and our cash profile.

We saw an opportunity during the second quarter to acquire what we viewed as being an incredibly attractive business with a very large market segment with differentiated solutions.

It was a small capital deployment. And we chose to move forward with that. The risk is, obviously, if that we had postponed that, that would have been scooped up by some other suitor in the marketplace, and we wanted to take advantage of the timing. And we felt very comfortable given that we are starting to see the markets recover to deploy that capital on M&A.

We have a full pipeline of M&A-related activity. But we're being very prudent in terms of our capital deployment. Certainly, the results in the third quarter that we're experiencing give us more confidence in the recovery and the trend, but we're continuing to be cautious.

And as we finish up the third quarter and look at what the fourth quarter holds, we'll update in terms of our confidence and our willingness to sort of get back in the M&A world and start to do some more bolt-on acquisitions.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got you. So Sensata has had low tax rate since the IPO. So can you maybe just talk about how should we think about your tax rate in the next 2 to 3 years?

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Jacob A. Sayer - *Sensata Technologies Holding plc - VP of Finance & CFO of Performance Sensing Gbu*

So the tax rate stem is from, a, where the top co is. So we're not a U.S. domicile business, we're domiciled in the U.K., which uses jurisdictional tax rate rather than a global tax rate. So the taxes that we pay globally are the summation of all the profits in all the different jurisdictions that we have around the globe. And by the way, that structure will -- even at a steady state, have a pretty low tax rate sort of in the mid-teens.

We're much lower than that today as a result of the interest expense and the tax shield that, that provides in certain jurisdictions and the result of some intangibles that were created at the time of the original acquisition by Bain Capital back in 2006, and those have been amortized into the P&L over time.

The tax rate has been jumping around a little bit as a percentage of PBT, as a result of the jumping around on PBT this year. But as a percentage of EBIT, it's about 8.5%, and that's -- that will be consistent for this year, for Q3 and Q4.

And we would expect that to tick up next year and the following year by about 50 to 100 basis points per year as some of those tax shields that we have expire in certain jurisdictions around the globe.

So we'll see a steady increase. And eventually, when we become a U.S. cash taxpayer as well, there will be another step-up that will take us into the mid-teens rate as a percentage of PBT.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Got you. Jeff, you have been with Sensata for more than a decade. You took the CEO role this year. But you were the COO and CFO of the company before the CEO position. As the new CEO, what milestones you would like to achieve for you and Sensata for the next 3 to 5 years?

Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Yes. So timing is everything, isn't it, Tim, in terms of taking it over. It's been -- I've been with Sensata now for almost 14 years. You know I joined the company in 2006 as the Chief Financial Officer, did spend a bunch of time as the Chief Operating Officer and spent time in sites around the world and also ran our 2 business segments. So it's been an incredible journey.

Obviously have a huge amount of passion for the company, but also what we do in terms of the impact that we have on the environment that we're operating.

In terms of changes, Martha and I worked very closely together. And before Martha, Tom and I worked very closely together. So I've had very close interaction with the prior 2 CEOs of the company.

I've been in lockstep with them in terms of the direction that the business is going. And that succession process is incredibly important. There's not a major shift in terms of where we're going as a result of me taking over but really an acceleration and focus of what we do as a company. We're going to continue to focus on more end market diversification so that we can weather the storm through these market cycles.

And we're going to continue to invest very heavily in these mega trends that are impacting the end markets that we serve that we believe are going to provide continued strong content growth and differentiated margins and cash flow and value creation for our shareholders.

Zhen Yang - *Citigroup Inc., Research Division - VP*

Great. I think we are running out of time. With that, I would like to personally thank Jeff and Jacob. Thanks for joining us today, and this concludes our Sensata session. Thanks for your time.

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Jeffrey J. Cote - *Sensata Technologies Holding plc - President, CEO & Director*

Thank you, Tim.

Jacob A. Sayer - *Sensata Technologies Holding plc - VP of Finance & CFO of Performance Sensing Gbu*

Thank you, Tim. Bye.

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