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ST.N - Q3 2021 Sensata Technologies Holding PLC Earnings Call

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OVERVIEW:

ST reported 3Q21 revenue of $951m, adjusted net income of $138.6m and adjusted EPS of $0.87. Co. expects 4Q21 revenue to be $895-925m and adjusted EPS to be $0.76-0.82.

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PRESENTATION

Operator

Good day, and welcome to the Sensata Technologies Q3 2021 Earnings Call. (Operator Instructions) Please note, this event is being recorded. I would now like to turn the conference over to Mr. Jacob Sayer, VP, Finance. Please go ahead.

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

Thank you, Sarah, and good morning, everyone. I would like to welcome you to Sensata's Third Quarter 2021 Earnings Conference Call. Joining me on today's call are Jeff Cote, Sensata's CEO and President; and Paul Vasington, Sensata's Chief Financial Officer.

In addition to the financial results press release we issued earlier today, we will be referencing a slide presentation during today's conference call. The PDF of this presentation can be downloaded from Sensata's Investor Relations website.

This conference call is being recorded, and we will post a replay webcast on our Investor Relations website shortly after the conclusion of today's call.

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As we begin, I would like to reference Sensata's safe harbor statement on Slide 2. During this conference call, we will make forward-looking statements regarding the future events where the financial performance of the company should involve risks and uncertainties.

The company's actual results may differ materially from the projections described in such statements. Factors that might cause such differences include, but are not limited to, those discussed in our Forms 10-Q and 10-K as well as other subsequent filings with the SEC.

On Slide 3, we show Sensata's GAAP results for the third quarter of 2021. 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 relate to our non-GAAP financial measures.

Reconciliations of our GAAP to non-GAAP financial measures are included in the earnings release and in our presentation materials. The company provides details of its segment operating income on Slides 12 and 13 of the presentation, which are the primary measures management uses to evaluate the performance of the business.

Jeff will begin today's call with highlights of our business during the third quarter of 2021, followed by a quick review of our first sustainability report published recently. He will then provide an update on recent progress in our key electrification and Sensata Insights' strategic growth areas. Paul will cover our detailed financials for the third quarter of 2021, including organic revenue growth and market outgrowth by business as well as segment performance. And he will also provide financial guidance for the fourth quarter of 2021. We'll then take your questions after our prepared remarks.

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

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

Thank you, Jacob, and welcome, everyone. I'd like to start with some summary thoughts on our strong performance during the third quarter of 2021, as outlined on Slide 4. The business recovery that began this time last year continued during the third quarter. We responded effectively to increased customer demand, which drove 20.6% revenue growth from the prior year period to $951 million, slightly above the guidance range we provided in July.

While automotive production was constrained during the quarter due to supply chain shortages, we were able to deliver our customers' orders and produce strong financial results for shareholders. Looking at our performance year-over-year, we once again produced strong market outgrowth well above our target ranges.

As a company, we delivered 1,190 basis points of outgrowth during the quarter. However, outgrowth is something that we monitor over a longer period of time than 1 quarter. And since 2018, on average, we have produced 570 basis points of outgrowth as a company, driven by 1,050 basis points of outgrowth in our heavy vehicle off-road business and 650 basis points of outgrowth in our automotive business.

This demonstrates the vital role we provide for our customers in these key markets. Paul will discuss our strong revenue outgrowth in more detail. Sensata's revenue outgrowth to market will increasingly be driven by our enhanced positioning in megatrend areas.

We continue to invest in these growth initiatives both organically and inorganically with Xirgo and now the pending acquisitions of Spear Power Systems, and SmartWitness, expanding not only our capabilities, but also our access to end markets and product portfolios in these pivotal areas.

Already, we have seen strong revenue growth coming from our electrification activities with more than $220 million estimated revenue this year. We expect continued significant growth in our megatrend areas over the coming years, driven by electrification trends, the infrastructure requirements to support electrification and the proliferation of IoT on stationary and mobile equipment.

Sensata today is in a very strong financial position, in part because of our excellent performance over the past year. We have generated more than $530 million in free cash flow over the past 12 months, and our current cash balance of $2 billion enabled Sensata to continue to acquire targeted innovative businesses that will expand our presence in our targeted growth vectors.

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During the third quarter, we benefited from our resilient, flexible and focused organization that continues to successfully navigate the ever-changing supply chain landscape and deliver on our customers' needs. Not surprisingly, we continue to see elevated costs related to the worldwide material shortages and logistics costs.

We are working diligently to limit those effects including a different commercial approach with our customers. This is a challenging exercise, but very necessary under the current circumstances. Despite these elevated costs, we delivered $201 million in adjusted operating income during the quarter, representing 21.1% in operating margin, substantially higher than the prior year period.

I'd like to recognize the innovation, agility and hard work of our entire team, achieving these strong results during the third quarter. During the quarter Sensata published its first sustainability report, and we're very proud of our progress in these areas.

Virtually every product Sensata makes today results in a cleaner, safer and more efficient world. We also take our responsibility to reduce the carbon emissions from our own operations and our supply chain very seriously. To that end, we are targeting a 10% reduction in our greenhouse gas emissions intensity by 2026, and we have established a goal to be carbon neutral by 2050, in line with leading companies around the world.

In addition, our report addresses sustainability topics core to Sensata's mission, including diversity, equity inclusion and responsible sourcing. We believe that diversity benefits our employees, customers and shareholders and that a diverse workforce makes us a better company.

We have established goals for our leadership team to improve female representation and management roles at Sensata to 30% and to reach 25% racial diversity in U.S. management roles by 2026, while reducing turnover, improving internal development and promotion rates.

We are serious about achieving meaningful progress against these goals and consequently are tying a portion of senior executive short-term incentive compensation to annual improvements. We look forward to keeping all our stakeholders updated on these and other important ESG initiatives in the coming years.

Moving to Slide 6. Sensata is making excellent progress in winning new business and electrification components, in part because we take a holistic view of electrification and its growing impact on all the segments we serve. Electric light vehicles capture a lot of attention. And Sensata provides the manufacturers of these vehicles with not only new EV-specific components, but also with many of our innovative and differentiated components from traditional vehicles like braking, tire and environmental control.

Specific to EVs, we also provide and are developing several components that enable safe and efficient operation of electrified platforms such as high-voltage electrical protection, advanced temperature sensing, highly sensitive electric motor position and next-generation current sensing. As an example, during the third quarter, we were awarded new E-motor position business with a large European OEM, representing $2.6 million in annual revenue.

In addition, we benefit from the upgrading of certain systems in EVs. For example, when the climate control system is upgraded to a heat pump to manage the temperature of both the cabin as well as the battery pack, the sensor package is upgraded and Sensata benefits. In the important area of braking, Sensata is a global leader. During the quarter, we won 2 new business opportunities that were significant, one with brake system leader, Continental for new electronic stability control systems covering both traditional internal combustion engine vehicles as well as a greater than $11 million in new business on electric vehicles that further extends our leadership position in that market.

We have described the revenue increase that we received from EVs as compared to internal combustion vehicles in terms of an average 20% uplift in content per vehicle. This is a demonstrated figure based on actual revenues and vehicle production. Our design win activity within electrification has been growing rapidly. We saw an 80% rise in electrification wins last year. And so far this year, approximately 50% of our automotive design wins are with electric vehicles. Another dramatic uptick from the prior periods.

Looking forward, based upon the business wins we're gaining and the products we are developing, we estimate that our battery electric vehicle content is on path to double that of an internal combustion engine vehicle on average within 5 years.

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On Slide 7, we show how Sensata is expanding in clean energy solutions, moving up the stack from high-voltage components used by large customers with the resources to design these into their electrified offerings to subsystems and full battery energy storage systems for customers in a multitude of end markets. Electrification is happening everywhere, not just in passenger vehicles. Manufacturers of bikes, heavy trucks, material handling equipment, marine vessels and even aircraft and spacecraft are addressing ever-tightening greenhouse gas emissions regulations and taking advantage of falling battery costs to provide electrified solutions to their customers.

However, not all of these customers can design all aspects of the electrified solution in-house. Thanks to capabilities we have added via acquisition, Sensata can now provide either the subsystem of assembled components to manage battery charging in the form of a power distribution unit, or using technology from lithium balance and Spear Power, we can provide the full energy storage system, including battery management and a customized battery pack.

By providing a full suite of offerings, our electrification and clean energy solutions, serviceable addressable market expands dramatically, reaching $15 billion by 2030. As an example of the solutions we offer during the quarter, a large premier European heavy vehicle OEM awarded Sensata design for a mega-watt size charging unit to help power their future electric commercial vehicles. This strategically important business win is worth more than $20 million in annualized revenue once it reaches its expected production run rate. This pivotal development means we can increase our content per heavy truck from the current 100 to 200 on average to more than 1,000 per electric heavy vehicle.

In addition, through the pending acquisition of Spear Power, we can provide full battery storage systems for a variety of specialty transportation markets. For example, Spear is powering electric ferries including the upgrading to electric of the Washington State Ferry system. These are highly demanding solutions that include very robust safety features proprietary to Spear and works excited above the roles Spear is playing in these and other land, sea and air transportation markets. Similar to what we did for our Insights Group back in June, in early 2022, we'll webcast a key chain covering our electrification components and clean energy solutions initiatives. So listeners can gain a better understanding of our offerings, the evolving markets and our go-to-market strategies in these key growth vectors for Sensata. We look forward to sharing more details about these rapidly growing involving areas then.

On Slide 8, we share an update on our continued progress in Sensata Insights. The Insights initiatives addresses a fast and growing market, and we're pleased by the traction we are gaining with both current and new customers across various sectors. The ongoing widespread semiconductor shortage is constraining our Insights business, and we are unable to deliver on all of that expanding demand.

You'll recall that these solutions are designed into customers' fleets, the revenue is sticky and so our orders are building for future delivery once these shortages subside.

Our Insights order book for delivery over the next 12 months now stands at more than $85 million. As evidenced by the value-added nature of our solutions, we were recently awarded new business with telematics service providers in a large global shipping company together worth more than $9 million of revenue over the next 12 months.

I'm also pleased to announce the expansion of our Insight offering with the pending acquisition of SmartWitness, a privately held innovator of video telematics technology for heavy and light-duty fleets. SmartWitness Solutions comprise proprietary software and hardware, purpose-built for telematics service providers providing a complementary fit with our Insights business.

Since its founding in 2007, SmartWitness has been a pioneer in video telematics that expands on traditional offerings to include contextually aware data capture that enhances the monitoring of vehicles, their surrounding -- and their surroundings to increase safety and lower insurance costs for fleets.

SmartWitness systems are logging 50 million miles of information every day. In sum, we're really encouraged by our continued progress in our megatrend growth initiatives. As I've said before, we see numerous opportunities to utilize our strong financial position, our engineering capabilities, our supply chain and our customer relationships to meaningfully enlarge our addressable markets through organic efforts as well as bolt-on acquisitions and partnerships within these megatrends.

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I'd now like to turn the call over to Paul.

Paul S. Vasington - *Sensata Technologies Holding plc - Executive VP & CFO*

Thank you, Jeff. Key highlights for the third quarter, as shown on Slide 10, include: revenue of $951 million, an increase of 20.6% from the third quarter of 2020. Organic revenue increased 16.6%. The acquisition of Xirgo increased revenue by 2.3% and changes in foreign currency increased revenue by 1.7%.

Adjusted operating income was $201 million, an increase of 29.8% compared to the third quarter of 2020, primarily due to higher revenues, partially offset by elevated costs related to the industry-wide supply chain shortages, higher spend to support megatrend growth initiatives and higher incentive compensation aligned to improve financial performance.

Adjusted net income was $138.6 million, an increase of 33.8% compared to the third quarter of 2020, largely due to the significant increase in operating income. Adjusted EPS was $0.87 in the third quarter, an increase of 31.8% compared to the prior year quarter.

Now I discuss our performance by end market in the third quarter of 2021 as outlined on Slide 11. Our organic revenue increase of 16.6% year-on-year includes market growth of 470 basis points and outgrowth of 1,190 basis points, again demonstrating Sensata's ability to consistently outgrow its end markets.

Our heavy vehicle off-road business posted our organic revenue increase of 58.9%, representing end market growth of 31.4% and 2,400 basis points of markup outgrowth in the third quarter. Our China on-road truck business continued to post better-than-expected growth from the adoption of NS VI emission regulations.

And we are also benefiting from a wave of electrical, mechanical operator controls being installed in new offer equipment. Our automotive business posted an organic revenue increase of 5.2%, representing end market contraction of 21.6% and 1,150 basis points of market outgrowth.

Our automotive business benefited from new product launches and powertrain and emissions, safety and electrification-related applications and systems. Recall, we saw an approximate $35 million inventory contraction a year ago as the automotive industry ramped up production from slowdowns, shutdowns earlier in 2020.

In addition, we were able to fulfill customers' orders within the current quarter, even if those shipments exceeded the eventual production in the quarter due to other component delays. Within the third quarter of 2021, we estimate an incremental build quarter-over-quarter of approximately $35 million of inventory at our customers. Our industrial business revenue increased 17.9% organically, as global industrial end markets continued to recover in the quarter.

Strong growth in new electrification launches and heating, ventilation and air conditioning, enabled our industrial business to grow faster than market this quarter. Our aerospace business increased 8.3% organically, reflecting somewhat improved OEM production and air traffic that later drives our aerospace aftermarket business. New product launches, primarily in defense and improvements in aftermarket enabled our aerospace business to grow faster than market this quarter.

Now I'd like to comment on the performance of our 2 business segments in the third quarter of 2021. Starting with Performance Sensing on Slide 12. Our Performance Sensing business reported revenues of $706.5 million, an increase of 21.6% compared to the same quarter last year. Excluding the positive impact from foreign currency of 1.8% and the positive impact from the Xirgo acquisition of 3.1%, Performance Sensing delivered 16.7% organic revenue growth.

Performance Sensing operating income was $193.7 million, an increase of 27.8% as compared to the same quarter last year, with operating margins of 27.4%. The increase in segment operating income was primarily due to higher revenues, somewhat offset by elevated costs related to the industry-wide supply chain shortage.

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Performance Sensing generated incremental margin of 37% in the quarter on higher organic revenue as compared to the prior year period. As shown on Slide 13, Sensing Solutions reported revenues of $244.6 million in the third quarter of 2021, an increase of 17.9% as compared to the same quarter last year. Excluding the positive impact of foreign currency of 1.5% Sensing Solutions delivered 16.4% organic revenue growth. Sensing Solutions' operating income was $75.3 million, an increase of 29.3% from the same quarter last year, with operating margins of 30.8%.

The increase in segment operating income was primarily due to higher revenues. Sensing Solutions generated incremental margin of 46% in the third quarter on higher organic revenue as compared to the prior year period. On Slide 14, corporate and other operating expenses not included in segment operating income were $72.7 million in the third quarter of 2021.

Excluding charges added back to our non-GAAP results, corporate and other costs were $65.7 million, an increase of $12.3 million from the prior year quarter, reflecting higher research and development and business development spend to support our megatrend growth initiatives and higher global incentive compensation costs aligned to our improving financial performance.

Slide 15 shows Sensata's third quarter 2021 non-GAAP results. Adjusted operating income increased 29.8% compared to the same quarter last year. And adjusted operating margin increased 150 basis points to 21.1%. The increase in both adjusted gross margin and adjusted operating margin largely reflects the rapid increase in revenue from depressed levels experienced last year due to the COVID-19 pandemic, offset somewhat by increased costs related to industry-wide supply chain shortages net of recovery of some of these costs from customers.

We've included on this slide an adjusted operating income margin log from the third quarter of 2020 to the third quarter of 2021. As shown on Slide 16, we generated $88 million in free cash flow during the third quarter. Free cash flow was impacted in the quarter by our decision to increase raw material purchases early in the quarter in order to maximize production flexibility given the widespread partial reduce in our supply chain.

For the full year, we currently expect free cash flow conversion to be approximately 80% of adjusted net income as a result of higher inventory levels. For the full year 2021, we expect capital expenditures to be in the range of $145 million to $155 million. Sensata's net debt-to-EBITDA ratio was 2.5x at the end of September, the bottom end of our target operating net leverage range. Sensata's primary use of cash on hand is to acquire businesses that will extend our market position within our key growth vectors of Electrification and Insights. In addition, we intend to resume our share repurchase program within the fourth quarter. And as noted, we have $302 million available on our current repurchase authorization.

We are providing financial guidance for the fourth quarter of 2021, as shown on Slide 17. Our expectations are based upon the end market outlook that I will discuss materially. We expect to generate revenues between $895 million and $925 million in the fourth quarter of 2021, representing a reported revenue change between a 1% decline and 2% growth compared to the fourth quarter of 2020, with the impact of foreign currency, increasing revenues at the midpoint of guidance by about $2.6 million.

Excluding the impact of foreign currency and the Xirgo acquisition, we expect an organic revenue change ranging from a 3% decline to flat in the fourth quarter. Our current fill rate is approximately 95% of the revenue guidance midpoint for the fourth quarter. We expect to report adjusted operating income between $180 million and $190 million. At the midpoint, adjusted operating income margin is expected to be 20.3%, which includes 100 basis points of increased operating costs associated with global supply chain shortages, net of customer recovery actions.

On the bottom line, we expect to report adjusted net income between $121 million and $131 million and adjusted EPS between $0.76 and $0.82, which includes a $0.02 increase of foreign currency at the guidance midpoint. At the bottom of the slide, we have provided an adjusted -- an adjusted operating income margin log for the fourth quarter of 2020 to the fourth quarter of 2021.

On Slide 18, we provide our revised estimates for OEM production growth for 2020 as compared to the expectations we shared in late July. We currently expect automotive production to be down approximately 3% this year from last year, given ongoing production slowdowns caused by global supply chain shortages. Our outlook is more conservative than IHS Automotive production estimates for the fourth quarter as we do not see production constraints from the global supply chain shortages lifting in the near term.

While we are not sharing specifics yet, the current IHS global automotive production expectations of 10% growth in 2022 suggest that supply chain shortages will be considerably next year, a view we do not share given current trends. We intend to provide detailed financial guidance for 2022

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during our fourth quarter earnings call in early February. However, at a high level, we currently expect Sensata's revenue growth in 2022 to align with the growth framework we have previously shared.

Sensata's revenue by end market should grow consistent with each market's production growth, plus our targeted outgrowth of approximately 400 to 500 basis points across the whole company. In addition, we intend to continue our serial M&A approach to further expand our market position in our megatrend areas, and we aim to have this activity at a material amount to revenue growth each year.

Now let me turn the call back to Jeff for closing comments.

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

Thanks, Paul. Let me wrap up with a few key messages as outlined on Slide 19. Sensata has responded very well to the rapid changes in many of our end markets, demonstrating the strength, resiliency and reliability of our business and organizational model, which enabled us to capitalize on this recovery and the end market demand and deliver for our customers.

Our quick response to shifting demand positions us well as a trusted resource for our customers. We are delivering consistently robust end market outgrowth. We remain confident in our ability to sustain this attractive end market outgrowth into the future based on our strong levels of new business awards, in our large and expanding pipeline of new opportunities.

We continue to invest in our megatrend-driven growth initiatives that are opening up large and rapidly growing opportunities for Sensata across all of our end markets. We are making excellent progress in electrified components, clean energy solutions and Sensata Insights, both through organically targeted areas around new business and through inorganic activity associated with bolt-on acquisitions.

We continue to believe that the overall business environment provides interesting opportunities to further strengthen our portfolio through strategically important value-creating acquisitions and/or joint ventures. In addition, we are pursuing new technology collaborations and partnerships with third parties to expand our capabilities and accelerate our megatrend-driven growth potential.

We expect to continue to deliver industry-leading margins for our shareholders, while also increasing investments in our growth opportunities and our people. And finally, I'm excited about Sensata's long-standing mission to help create a cleaner, safer and more connected world, not just through our customers' products but also through our own operations.

We believe we are meaningfully contributing to a better world. We are incorporating ESG considerations into our strategy, as illustrated in our new sustainability report to bolster the long-term sustainability and success of the company for all of its stakeholders. We look forward to reporting more about our progress in these areas in future updates. Now I'll turn the call back to Jacob.

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

Thank you, Jeff. We'll now move to Q&A. Given the large number of listeners on the call, please limit yourself to 1 question each. Sarah, please go ahead and assemble the Q&A roster.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Wamsi Mohan with Bank of America.

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Wamsi Mohan - *BofA Securities, Research Division - Director*

I was wondering if you could maybe just give us some more color on the channel fill dynamics, how broad-based this is. If we use $30 to $40 of content per vehicle, we're talking about roughly 1 million units. But the production changes are quite large. And Jeff, you noted that going into '22, it seems that IHS maybe is a bit too optimistic. So is the guide sort of a 4Q encapsulating all the channel inventory dynamics? Or do you think this persists into 2022? And if I could, could you also just maybe quickly talk about the China issues, both around power rationalization and resurgence of COVID, if you're seeing any impact from that?

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

Sure. So let me touch on Q4. So IHS forecast automotive production at about $16.5 million, $16.6 million. We've called it lower than that, about $15 million. In addition, given that we know there has been some of our parts built up in inventory, we are expecting a little bit of depletion on that. I think that's a little bit of a conservative guide, but we're watching it closely.

We want to make sure that we're not going above and beyond to deliver for customers so they could just have it sit in inventory. We'd rather address that as it occurs and serve other customers because the shortage is impacting all of our customers and all of the end markets.

As it relates to 2022, a couple of dynamics there. Obviously, we're not providing guidance for '22, but we would like to look ahead as everybody does. Specific as it relates to the automotive market, the call right now, traditionally, IHS has been a little bit more aggressive in terms of their call. When we look at the supply chain challenges that we're facing, the bad news is I think it will extend into 2022.

The good news is that based upon the commit levels that we're seeing from our suppliers would suggest that fourth quarter may be the low point in terms of the ability to deliver. So as some of that capacity -- increased capacity comes online, we think there will be a mitigation from the fourth quarter level. So it will start to taper a little bit.

So we'll keep monitoring that and give a perspective. But we're very mindful of that. We're mindful of the inventory that's been built. We're also mindful of the fact that North American vehicle inventory is at an all-time low 24 days. So that's going to need to be replenished at some point.

So there are a lot of moving parts in terms of the overall look. And obviously, you have to look at the other end markets that we serve. Automotive is a big one that we serve. But when you look at the others, there is a continued opportunity for growth in those markets as we go into Q4 and also into 2022.

And I've lost -- the question on China, I think, is just around what's happening there in terms of COVID and so forth. The business is operating quite well there. It's amazing how resilient we have been, but everybody has been in terms of managing through this. We don't see any impact right now in terms of COVID other than we're continuing with protocols. In the U.S., we're addressing the executive order associated with vaccine mandates.

So there's still a lot of stuff that's happening in terms of engagement with our employees and making sure we keep them safe. But all in, I feel as though it's become a little bit of the new norm for us, and we're managing through that very well. Hopefully, that answers your question, Wamsi.

Operator

Our next question comes from Matt Sheerin with Stifel.

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Matthew John Sheerin - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Senior Equity Research Analyst*

Yes. Jeff, I just wanted to ask regarding your comment about doubling the EV content in light vehicles in the next 5 years from the base of about, I guess, 20% incremental content today. Where in that product portfolio, would you see that coming? Is that from your existing products and technologies? Or are there other incremental products or areas that you're looking at?

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

A little of both. But candidly, based upon my comments, I think the listeners probably can appreciate that we tend to be fairly digital in terms of what we've demonstrated. We got a lot of feedback that the 20% uplift was good, but not hugely exciting.

We went back and realized that, that is demonstrated capability that we're experiencing right now. We've seen a very dramatic uplift in the wins that we've seen around electrified components with our automotive OEMs, but also with our other customers.

We've talked about power distribution units and other major wins associated with electrification. And what we've now done is gone back and said, okay, based upon the transition that we would expect, no one's going to get it perfectly right, but we know there's going to be a transition to migration more towards electrified vehicles.

As we look at that and we also look at what we've sold with customers, already, we see a line of sight to that doubling. The thing is we quote net NBOs. So when there is a -- there isn't a new socket, but it's the same socket in the new application. That wouldn't count toward our NBO growth.

And as we've said, there's a lot of content on vehicles that applies in battery electric vehicles as well as internal combustion engines. So we don't have to refill that pipeline. But a further evaluation of that trend, continued wins, more investment that we're making, partnerships we're striking allow us to feel very confident in that trend in terms of being able to double the content per vehicle. Hopefully, that's helpful.

Operator

Our next question comes from Amit Daryanani with Evercore.

Amit Jawaharlaz Daryanani - *Evercore ISI Institutional Equities, Research Division - Senior MD & Fundamental Research Analyst*

I guess my question really -- Jeff, it's you, but I think when you talk about the December quarter guide, you're sort of implying that Sensata's auto revenues will undergo auto production trends as that's due to depletion of your inventory that's sitting in the channel. Is that fair -- is there a way to think about how much extra inventory Sensata's out in the channel and how long does it take to normalize? And if I could just ask, Paul, could you just remind me how this free cash flow rewards back to this 80% conversion? And does that happen in December? Or is that -- is it more a calendar '22 narrative?

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

Yes. So I'll hit the Q4 and then Paul can hit the other topic. So we've already stated, we're expecting about 1.5 million units less than IHS in terms of actual production in the fourth quarter. But we also expect some of the inventory in the supply chain to deplete. So that's big into the guide that we provided for the fourth quarter.

In terms of the amount of inventory, call it $100 million, $125 million of inventory across the company that's been built. That's been largely over the last year. That's been largely focused in auto. But I would also point out that if you also look at the North American vehicle inventory of 24 days, just replenishing that back to a more normalized 50 or 60 would absorb a lot of that inventory in the market.

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But as that production occurs as that production is quoted, assuming our customers actually normalize their raw inventory, we will see production exceed our revenue. Now I think it's a bit of a discussion that we're having with customers because they want all the parts we can make for them, right? They want to make sure that given the complexity of their bills, they're very willing to carry a little bit more raw material now, but we want to make sure, again, that we're serving all of our customers, and it makes no sense for us to pay higher logistics costs and expedite fees to get customers' product that sits in their inventory. So that's an ongoing dialogue that we're having, and we'll continue to manage it very closely and give you updates as we see it.

Paul S. Vasington - *Sensata Technologies Holding plc - Executive VP & CFO*

So the question, I think, is the 80% conversion related to 2021. It's lower than we originally anticipated when we started the year and we made a conscious decision to build inventory, take on raw materials earlier to make sure that we were able to serve customers' needs, a conscious decision. For next year, I mean, we've been looking at a free cash conversion rate in the mid-80s. And that's what we're going to continue to target as good performance versus thought.

Operator

Our next question comes from Mark Delaney with Goldman Sachs.

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

So I think if you can elaborate on the supply chain dynamic that's underpinning some of the more cautious comments the company is providing as it thinks about the outlook for 4Q and also into next year. What are some of the most difficult things as it relates to supply chain for Sensata? Any particular components that are most short for the company. And if you could talk about the shortages you're seeing not only for Sensata, but what do you think is maybe impacting some of your customers as well? And any added color on that, I think, would be helpful.

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

Yes, sure. So first, obviously, it's an industry issue. I think everybody understands that it's not specific to Sensata. It's most acute in electronics at the foundry level, so capacity at the foundry level, I think these are sort of pretty well-known facts. And in that capacity it takes a while to get put in place.

Now over the last 18 months, as that's been happening, obviously, our suppliers have been moving their capacity around to serve needs. I think we've done really well in terms of getting our fair share of that allocation. So that's a very positive thing.

It's beyond electronics, though. I mean, we all experience it in our every day. Everything is short today, right? Supply chain issues, not only at capacity-demand question, but just logistics in general is very challenged in terms of finding labor to unload container trucks and so forth.

So it continues to be a problem that everyone is experiencing. As we've talked about in the past, many of our electronics are customized. So we feel as though we've been impacted less as a result of that because in a lot of cases, those are areas that our suppliers would focus on as opposed to more standard off-the-shelf electronics. Candidly, that's what's impacting our Insights business a little more. The solution is differentiated and customized but saw a lot of the electronics that go into it are more standards.

So we're seeing a little bit more of a shortage in a crunch when there are standard ASICs that we're going after. And then the last point I would make here is during 2021, first half of the year, we were being partners with our customers and we didn't go after a lot of this cost recovery, but the second half of '21, we've had more direct conversations with them.

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We've had some very good success. And given that this is going to continue both in terms of raw material costs and logistics costs. We're having those conversations with customers to make sure that Sensata shareholders are not the ones that take the hit. We want to be good partners. We want to deliver, but we need to share in the costs associated with making sure we can continue to deliver.

Operator

Our next question comes from Luke Junk with Baird.

Luke L. Junk - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Jeff, I was hoping you could comment further on the view that content here is on a path to double ICEs within the next 5 years. And I was hoping if we could specifically talk about some of the key levers and drivers that you're looking at. In particular, any products you see growing in importance for Sensata? And maybe the best ones to look at this would be, directionally, if we look at power-related products versus traditional sensing products. Is there something -- any additional color would be appreciated.

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

Sure. Yes. So if you were to rewind the clock 3, 5 years, most of our components were obviously serving largely combustion engines. We've been very transparent about the activity that we've been undergoing in terms of M&A activity and additional engineering investment to make sure that we can serve our customers going forward.

So that's the backdrop, right? We've always talked about the fact that although we have expertise in individual sensing parameters pressure, as an example, temperature, position, we have thousands of products that we bring to our customers. We take modular technology, and we package it in a way that serves the application with those traditional sensing parameters.

It's not a lot different in the electrified world. So if you think of our contactor capability, we have the GIGAVAC capability, we have the capability with higher levitation. We have E-motor position that we've transformed from position sensors that we have. We have a building capability around current sensing. A lot of our pressure and temperature apply in terms of the environment for an electric platform.

So the goal is not to have 1 capability that we're relying on. It's to make sure that we're ubiquitous in terms of an EV platform. And the combination of the capabilities and product solutions that we have for an over built on by the other applications, like high-voltage current sensing and also protection we feel as though we've got a really good portfolio right now to be able to go to customers and help them solve the challenges that they're facing.

We'll continue to work at it, right? I mean it's a very small portion of the fleet yet, but there are a lot of wins that we're getting associated with solutions that we're bringing to our customers. And it's been a very rapid growth of development around opportunities as we're working with those customers to bring things to market very quickly. And that trend has created more confidence in our ability to see this being a real significant tailwind to us as a company.

Operator

Our next question comes from Brian Johnson with Barclays.

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

Just want to flesh a little bit more the inventory question. I guess first question is, a lot of the pure auto suppliers have very severe decrementals due to top start nature production in the quarter. Is most of the work you do in automotive from a catalog and therefore not customized to an OEM. And does that allow you to have smoother decrementals when 1 model up, 1 factory is up, 1 factory is down on your customers' end?

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

Yes, definitely not every one of our products. We have 15,000 different products that we bring to customers. They're not drop in. They are very much customized to the application, many -- very frequently sole-sourced with them. I would just say that we've built inventory and I think we've managed through this better. We're not the bottleneck, right, with our customers, which is a nice place to be.

We're in escalation with a lot of customers, but I'll tell you, I've talked with a lot of them. And the feedback I get is we're not the biggest problem. That's good. I like not being the biggest problem, and I'm okay with building a little bit of inventory to give a buffer, if you will, to our customers.

But I do want to make sure that it doesn't get out of hand because eventually, it's going to come around, right? They're going to take that inventory out at some point and then will lag the performance. So we don't want great performance during a tough time to result in a negative in the long term. So we're keeping a close eye on it.

Operator

Our next question comes from Samik Chatterjee with JPMorgan.

Samik Chatterjee - *JPMorgan Chase & Co, Research Division - Analyst*

Yes. It's Samik Chatterjee. Jeff, I guess when you outlined the content outperformance since 2018. And I think previously the narrative was about 400 to 600 basis points outperformance and you've consistently done better than that in both autos as well as heavy vehicles.

So I'm just thinking with the road map that you have on electrification and battery electric vehicles, when -- what are you thinking in terms of visibility, in terms of raising that outperformance guide?

And is it -- are there any concerns about hitting an air pocket as the transition happens in the industry? Or is it pretty much smooth sailing from here in that content outperformance should really start to continue to build from that level?

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

Yes. Thanks, Samik. So historically, we've referenced outgrowth in automotive and HVOR. I think to just make the story simpler. And by the way, we did that because of mix in the business and how it grows and so forth. We did it to create more transparency, but I fear that we might have complicated the story.

At the end of the day, our goal is to make sure that as a company, we have outgrowth over market. We know markets will ebb and flow. That's the nature of the end markets that we serve. And that's why we've quoted the 570 basis points since '18 across the company. It's really driven by HVOR and auto, but we do see outgrowth in industrial and aerospace as well, just not as pronounced.

The call for 400 to 500 go forward and our confidence in that. Again, it's what we have really strong confidence in. The more near term, outgrowth exceeding the targets is it has a lot to do with you're off a smaller base in 2020. So once we get into a more normalized environment, we would expect those outgrowth numbers to normalize a little bit.

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And so we just want more time where we've demonstrated beating the target before we raise. We're going to share what we have high level of confidence in. But certainly, we've demonstrated the ability to do better than what we've said and we'll aim to keep doing that, but we feel really comfortable with the forward 400 to 500 across the company and then the other quotes of 4 to 6 in auto and 6 to 8 in HVOR going forward. So hopefully, that helps.

Operator

Our next question comes from Michael Filatov with Berenberg.

Michael R. Filatov - *Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst*

Just on the doubling of the EV content, not to be the dead horse there. just the margin profile of that extra content you're seeing on electric vehicles. Could you maybe talk about how that will impact sort of the business margin and maybe where that margin profile is more attractive within the actual electric vehicle content mix?

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

Yes. So we exclusively focus on really hard to do applications that will achieve differentiated margins. So we steer very clear of commoditized applications that -- and huge commoditized that's probably unfair, applications that can be served with semiconductor packaging that don't require any sophisticated packaging and calibration, environmental control for harsh environments.

They're valuable sockets, but others can serve them. Where we do really well is in applications that are hard to do in harsh environments, and that's where we bring a lot of capability. We always focus on them, right? And so we're not going to deviate. That generates the premier margins that we experience as a company.

Now let me speak to how that will transition on new product launches. We've always seen new products that are at lower volumes have lower margins as they ramp, right? You're getting the kinks worked out of the automated manufacturing, you're gaining scale on your raw materials, you're utilizing your factory capabilities in terms of absorption, your yields start to increase dramatically.

But we're factoring that in. We don't see this transition as being hugely disruptive. The long-term margin profile of these products that we're engaging with our customers on will continue to have the differentiated margin profile that we have as an organization, as a company, and we'll continue to make sure we do that. It's not -- It doesn't just happen, right? It's the building of the scale. It's making sure that we're constantly redesigning, sourcing differently to make sure that we can drive the margin profile and make sure that we're competitive from a cost standpoint.

Operator

Our next question comes from William Stein with Truist Securities.

William Stein - *Truist Securities, Inc., Research Division - MD*

We've spoken quite a bit about inventory levels. But I still have a question about it. I'm looking to hopefully distill all of it into 1 comment. So can you remind us to what degree the inventory that you -- the excess inventory at your customers that you cited last quarter, do you believe was in raw form to them? In other words, they were holding your part versus in a car that was 99% complete, just waiting for 1 semiconductor to drop in. Can you also remind us of the dollar of inventory you believe was in excess last quarter, what that is this quarter again because I've heard a couple of numbers, but I might have missed it. And then the timing that you expect that inventory to be depleted and if that wasn't enough, maybe also talk about the planned inventory builds that we've heard OEMs want to do for strategic components. Does that affect your orders as part build planned. Sorry for the long-winded question.

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Paul S. Vasington - *Sensata Technologies Holding plc - Executive VP & CFO*

Will, I'll try to fill this down to something simple. So we built -- we believe that our customers built about $25 million of inventory in Q2 and $35 million this quarter. And so we're shipping to them above production.

With that said, given the fact that we think we're a very good supplier, we're not bottleneck, the assumption would be, and there's no facts to support that a lot of our parts are probably sitting in vehicles that are work in progress that will get released to the market at some point.

Given the fact that we're shipping well, we're having lots of discussions to meet their quarter demand, there's a lot of anxiety in the supply chain. And so that's how I would stack it up in terms of what's happening this year. Hard to say when it's going to unwind. But to Jeff's point, there's a lot of -- inventory levels in the dealerships are very well. So likely that's something that we'll need to get rebuilt. And so that's positive. That's a positive tailwind to what being seen right now.

I don't think that's going to change much in the current supply chain constraints that we're seeing, but it's likely a longer term, mitigating factors to some of the inventory that's been built in the channel today.

Operator

Our next question comes from Nik Todorov with Longbow.

Nikolay Todorov - *Longbow Research LLC - Analyst*

Jeff, I think I heard you talked about implementing a differentiated or different commercial approach to addressing the rising costs. Maybe can you expand there? What are you doing differently when you negotiate those with direct customers? And then maybe can you talk about how much of the inflation costs you've seen so far, you've been able to pass through to direct customers so far this year? And how should the investors think about once we start the new calendar year in terms of passing through those?

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

Sure. So 2021, we've recovered about half of the cost that we've incurred and given that we're expecting those costs to continue, we're going to aim to get all of that going forward. Certainly, we've been able to achieve that in Q3 and Q4. So I had mentioned that in the first half of the year, we sort of held off on that until we determined whether or not it was going to be persistent.

And it's not one size fits all. Every customer is different and the trade-offs are unique. And so -- but it's very strategic in terms of how we're engaging with customers to optimize all of the levers that we have available. But we're committed to making sure that we serve our customers, but that we share in the costs associated with achieving now.

Operator

Our next question comes from Rod Lache with Wolfe Research.

Shreyas Patil - *Wolfe Research, LLC - Research Analyst*

This is Shreyas on for Rod. So just wanted to clarify a couple of points. So I think you had mentioned earlier, there was about $100 million to $125 million of inventory build that you've experienced so far this year. So should we be assuming that inventory basically unwinds as we go through Q4 and then probably into next year? And is that embedded in that 4 to 5 points of growth over market that you were kind of talking about before?

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And then you mentioned that you're starting to see a recovery in some of the supply chain costs that you've been incurring this year. So does that suggest that all else equal, the headwind that you're experiencing this year would likely moderate if you continue to receive those recoveries?

Paul S. Vasington - *Sensata Technologies Holding plc - Executive VP & CFO*

So it's Paul. A couple of things. We talked -- there's a year-over-year impact that after taking into consideration. Last year inventory were contracting, this year where they're building. So we look at it on a year-over-year basis, it's bigger than whatever got built this year because we had inventory contracting last year.

As it relates to Q4, we've been benefiting from this build shipping above production. In Q4, we're assuming we're going to be pretty much delivering to production. But last year, there was a contraction. So it's how you want to think about year-over-year versus sequential. But just think of Q4 as largely related to the production that's being estimated we're estimating at 15 is what we're going to serve, 15 million cars excluded in the fourth quarter.

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

And the only other thing I'd mention is I think you commented about the outgrowth, we exclude inventory from the outgrowth that we have in the market when it's material.

Operator

Our next question comes from Joseph Spak with RBC Capital Markets.

Joseph Robert Spak - *RBC Capital Markets, Research Division - Autos and Leisure Analyst*

And not to beat a dead horse here, but I know you're sort of talking about your fourth quarter outlook below IHS. And I know we got to make some adjustments there because you look at it on your mix basis and exclude Xirgo, et cetera. But even if you do that, it seems like production is at least flattish, if not still higher than the third quarter, and then you're guiding the total revenues down sequentially. So it does seem like you're assuming a good amount of that inventory unwinds. And I'm just trying to understand that because going back to Paul, your comments, I mean, it seems like the automakers might not really be in a position to have that happen in the near term given the dealer inventory situation. So I just want to try to square those 2 sentiments.

Paul S. Vasington - *Sensata Technologies Holding plc - Executive VP & CFO*

Just trying to get really simple. I mean, our Q3 revenue production was $14.4 million but we benefited from inventory build, right? In Q4, production is $15 million, so it's up about 4%. We're not assuming that inventory build will continue. That's the difference. And our automotive business is slightly down. You're right, most sequentially. Those are the dynamics because we're not expecting to get that additional revenue from shipping more than what's being produced at the OEM.

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

Yes. That's auto, right? So on HVOR Q3 to Q4, we're expecting the market to contract a little bit. Industrial Q3 to Q4, we're expecting the market to contract a little bit.

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Joseph Robert Spak - *RBC Capital Markets, Research Division - Autos and Leisure Analyst*

That's seasonal.

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

Yes, that's seasonal, right? But that has to be factored into the Q3, Q4 transition as well. Aero is the other one that's up a tiny bit from Q3 to Q4. So when you look at the whole mix of the business, it's complicated. But when you look at the whole mix, the guide makes sense, and it's just a lot of moving.

Paul S. Vasington - *Sensata Technologies Holding plc - Executive VP & CFO*

And the fill is 95%, a little bit less than last quarter, but last quarter, we're expecting more orders to drop out given some of the shutdowns. We're expecting a little less of that. So that's why the fill being a bit lower, we think is appropriate given where we're forecasting the revenue to be at the point guide. It's largely consistent with what we saw in Q3.

Operator

Our next question comes from David Kelley with Jefferies.

David Lee Kelley - *Jefferies LLC, Research Division - Equity Analyst*

Maybe just a question on the fourth quarter margin guidance and the sequential view of the step down from Q3, I'm assuming in part related to the sequential guided revenue step down. But could you just give us a sense of how you're thinking about some of the sequential input cost levers into the fourth quarter? Or if there's anything mix related we should be thinking through in modeling?

Paul S. Vasington - *Sensata Technologies Holding plc - Executive VP & CFO*

You've got it right. The difference from Q3 to Q4, the drop we're dropping about $40 million-ish in the revenue and about $16 million is coming out on the bottom line. So it's -- a lot of it is just volume conversion and leverage that we lose. There is a little bit of an expectation of higher logistics costs as logistics rates continue to just given the constraints are global logistics channels. Those would be the 2 main drivers sequentially.

Operator

Our next question comes from Chris Snyder with UBS.

Christopher M. Snyder - *UBS Investment Bank, Research Division - Analyst*

Also just kind of want to follow up on the commentary on the EV content per vehicle can be double ICE within 5 years because this is a really significant change from the recent plus 20% run rate. So this trying to impact us more. I guess it's not super clear to me what is driving that 80% delta relative to expectations, just 3 to 6 months ago. Is it that the market opportunity is stronger than previously thought? Are our share gains accelerating kind of based on what you're seeing on orders? And I just want to confirm this does not include incremental M&A?

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Paul S. Vasington - *Sensata Technologies Holding plc - Executive VP & CFO*

Yes, it does not include incremental M&A. And so the -- again, the 20% is a demonstrated capability. If you take in 2020 and 2021 total revenue from electric vehicles divided by electric vehicles produced. It's a 20% uplift from the balance of the automotive business, right?

So it's a demonstrated. There's a lot that needs to happen in terms of seeing how those vehicle platforms roll out. But the -- a lot of the business is, one, we have a long-cycle business, right? So the last several years, we've quoted the amount of new business wins that we've had that are really specifically focused on electric vehicles. We're getting a better feel for what capability or what products that we have will port right over into the new electrified platforms as our customers start to put the finishing touches on their launch schedules associated with those.

And so we're just providing the visibility into the next 3 to 5 years, what we see and how that will transition. It's -- no one knows that the final answer is to how many electric vehicles, but if you use a 25%, 30% total electric vehicle park and 5 years, market is going to grow, content is going to continue to grow.

And obviously, in electric vehicles, we're going to continue to see incremental content on those vehicles in the light vehicle market, but even more accentuated in some of the stationary equipment in every vehicle market where we're providing more than just sensor content. So it continues to be a really exciting, fast-moving area that will continue to provide data points and reference points so that you can monitor our progress.

Operator

Our next question comes from Joe Giordano with Cowen.

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

I think we've got some of the things at this point, but just curious your when you scale your content, and things like that, like what does that contemplate in terms of megatrend spend associated with that? And particularly, as you do all these kind of bolt-on, does that megatrend number ramp with that? How do you kind of see that going over the next couple of years?

Paul S. Vasington - *Sensata Technologies Holding plc - Executive VP & CFO*

I think for next year, we're -- our current planning model is to staying at $50 million, $55 million range for megatrend spend. The composition of that spend may change. It may end up pivoting more towards where we think the success will be in terms of scaling growth. So more to come on that as we develop our guide for next year with an aggregate number. Right now, the target is about -- keep it at that $55 million level.

Operator

Our next question comes from James Suva with Citi.

James Dickey Suva - *Citigroup Inc., Research Division - MD & Research Analyst*

A question on the logistics and the supply chain issues. Are you having to -- or starting to consider put into your contracts like additional riders or, I guess, indexing to raw materials or shipping or things like that? Because I'm just wondering if these things are prolonged so it could potentially protect your profitability somewhere. I'm just kind of wondering how it's going because I know you have very long-term relationships with your customers in a long sight of visibility into the designs.

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

Yes. So it's a great question, Jim. Typical contracts, it was not unusual to have rate of exchange riders or metal commodity riders in them, but inflation riders are something that I don't -- haven't seen in a lot of commercial agreements, but we're clearly having those conversations that's the legal side of it. The reality is, is that our customers want us to be able to serve them. We do have very long-standing decades long relationships with our customers. and we'll get to the right answer with them in terms of navigating through this challenge.

Again, it's not -- it's never an easy conversation to have this type of discussion with customers. But they understand the world we're living in. They understand the world that everybody is living in. And for the most part, we feel good. But we will drive more into the contractual element, but it's a dialogue with them around how we partner.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to Jacob Sayer for any closing remarks.

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

I'd like to thank everyone for joining us this morning and for hanging in there through all those questions. Sensata will be participating in upcoming investor conferences this quarter, including Baird's Industrial Conference and the Melius Industrial Conference in New York during the quarter. As Jeff mentioned, we also expect to offer a webinar on our electrification components in Clean Energy Solutions initiatives early next year.

We look forward to seeing you at one of those events or on our fourth quarter earnings call in early February. Thank you all for joining us this morning and for your interest in Sensata. Operator, you may now end the call.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

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