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EDITED TRANSCRIPT

ST.N - Q2 2023 Sensata Technologies Holding PLC Earnings Call

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OVERVIEW:

Company reported Adjusted operating income of $206 million, Adjusted net income of $149 million, adjusted earnings per share of $0.97, adjusted earnings per share of $1.02, revenues of $757.4 million, operating income of $191.1 million, revenues of $304.7 million, operating income of $84.2 million, free cash flow of $68 million.

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PRESENTATION

Operator

Good day, and welcome to Sensata Technologies Q2 2023 Earnings Call. (Operator Instructions) Please note, this event is being recorded.

I now will turn the conference over to Mr. Jacob Sayer, Vice President of Finance. Please go ahead.

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

Thank you, Keith, and good morning, everybody. I'd like to welcome you to Sensata's Second Quarter 2023 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.

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

Factors that might cause 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. We encourage you to review our GAAP financial statements in addition to today's presentation. Most of the information that we will discuss during today's call will relate to non-GAAP financial measures. Our GAAP and non-GAAP financials, including reconciliations are included in our earnings release and in the appendices of our presentation materials.

The company provides details of its segment operating income on Slides 7 and 8 of the presentation, which are the primary measures management uses to evaluate the performance of the business. Jeff will begin today with highlights of our business results during the second quarter. He will then provide a few updates on exciting electrification product launches. Paul will cover our detailed financials for the second quarter, updates on

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capital deployment, and he will discuss our financial guidance for the third quarter of 2023. 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'll start with some summary thoughts on our robust performance during the second quarter, as outlined on Slide 3. During the second quarter, we produced a record $1,062 million in revenue, up 4.1% from the prior year period and above our guidance range despite a 140 basis point headwind from foreign currency.

Adjusted operating income of $206 million was at the top end of our range. Adjusted operating income margins increased by 40 basis points from the prior year period or 110 basis points on a constant currency basis as we continue to focus on improving our margins.

Adjusted net income moved higher by 15% to $149 million, and adjusted earnings per share grew 17% from the prior period or 23% on a constant currency basis to a record $0.97.

Our customers' supply chain show meaningful signs of returning to normal. Consequently, we believe customers reduced channel inventory to better align material on hand with their production. We estimate this impact was approximately $20 million or 200 basis points across the company in the second quarter, concentrated in automotive and heavy vehicle off-road.

Taking that into account, market outgrowth for the last 12 months remained within our target range of approximately 535 basis points. As we've said, outgrowth can be lumpy in any quarter, and the second quarter results continue to be impacted by electric vehicle launch schedules. We remain confident in our long-term outgrowth range given our business wins, new product development activities and future launch schedules. Outgrowth to market since the beginning of 2020 has averaged 735 basis points.

I'm also pleased that we remain on track to achieve our long-term goal of $2 billion in electrification revenue across the company by 2026. With that revenue growing strongly in the second quarter. In a moment, I will outline exciting new product launches that will help further propel that growth.

At the beginning of 2023, we outlined a shift in our capital deployment strategy based upon our confidence and our capabilities to effectively intersect the electrification growth vector and deliver innovative solutions to our customers. We continue to execute that strategy during the second quarter, removing variable rate debt from our balance sheet and returning capital to shareholders in the form of debt repayments, the dividend and share repurchases. Considering current interest rate trends, that decision has made strong business sense.

Our capital allocation strategy reduces risk in our capital structure, lowers interest expense, improves adjusted net income and earnings per share as well as return on invested capital. The end market Sensata serves are expected to experience significant change over the next 10 years, as our customers transform their businesses and product portfolios to adjust to decarbonization trends. Electrification will impact all the end markets we serve. And as we have done repeatedly over our history, we've adapted to market trends. Sensata is focused on continually innovating to help customers solve their mission-critical, hard-to-do engineering challenges on this path toward electrification.

As shown on Slide 4, I'd like to share some thoughts on new products that will help drive our electrification revenue going forward. In renewable power generation, solar energy developers and others are poised to benefit from global initiatives to decarbonized sources of energy, including last year's Inflation Reduction Act in the United States, which provides significant long-term funding to this industry.

To address a key need for this industry, we are launching a fifth-generation line of inverters that contain 3x the power density of its predecessor, creating a highly attractive value proposition for customers. These products, which are launching this quarter are designed to enable new solar and other renewable energy installations to connect seamlessly to the electricity grid. Serving the needs of these installations represents a fast-growing $2.5 billion addressable market for Sensata.

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In addition, we have launched a new battery management system to help address the electrification needs of material handling, work truck and bus OEMs. The BMS is an intelligent component of the battery pack, responsible for advanced monitoring and management of current. Think of it as the brain behind the battery. It plays a critical role in assessing the battery safety, performance, charge rates and longevity. Sensata's N3 battery management system is ASIL-C, and ISO certified off the shelf and offers software flexibility, thus reducing development time and cost for customers. These battery management systems seamlessly manage the very high power requirements that OEMs face and represent a $350 million addressable market by 2028.

I'll now turn the call over to Paul.

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

Thank you, Jeff. Key highlights for the second quarter, as shown on Slide 6, include: record revenue of $1,062 million, an increase of 4.1% in the second quarter of 2022. Revenue growth reflected market growth of approximately 2.5%, inventory contraction of approximately 2% and market outgrowth of approximately 2.9% as well as the net impact of acquisitions and divestitures in the quarter, partially offset by foreign currency headwinds.

Adjusted operating income was $206 million, an increase of 6.2% compared to the second quarter of 2022. This increase was primarily due to higher volume, pricing and productivity improvements, partially offset by the impact from acquisitions and divestitures last year, and the unfavorable movements in foreign currencies.

Adjusted operating margins improved 110 basis points from the prior year period on a constant currency basis due to operational improvements within the business. This represents very strong 39% incremental margins on a constant currency basis and over 80% incremental margins organically.

Record adjusted earnings per share of $0.97 in the second quarter grew 17% from the prior year quarter, faster than adjusted operating income due to lower interest expense, a lower cash tax rate and a lower share count. On a constant currency basis, adjusted earnings per share would have been $1.02, representing 23% growth from the prior year period.

Now I'd like to comment on the performance of our 2 business segments in the second quarter of 2023, starting with Performance Sensing on Slide 7. Our Performance Sensing business reported revenues of $757.4 million, an increase of 3.5% compared to the same quarter last year. Automotive revenue increased due to market growth, content launches and higher pricing, partially offset by the unfavorable revenue mix, inventory destocking, slow new product launch ramps in foreign currency.

Growth in heavy vehicle off-road revenue reflects market and content growth, partially offset by inventory destocking and unfavorable foreign currency. Performance Sensing operating income was $191.1 million, with operating margins of 25.2%. Segment operating margins increased year-over-year, largely due to improved pricing, higher volumes and productivity, partially offset by unfavorable foreign currency. Excluding the foreign currency impact, Performance Sensing operating margin would have been 26%.

At the start of the quarter, Sensata moved the reporting of certain material handling products from heavy vehicle off-road in performance sensing to industrial and sensing solutions to reflect changes in our reporting structure. Prior periods have been restated to reflect this change.

As shown on Slide 8, Sensing Solutions reported revenues of $304.7 million in the second quarter, an increase of 5.5% as compared to the same quarter last year. Industrial revenue increased due to strong acquired revenue growth in electrification, offset somewhat by weaker markets, especially in HVAC and appliance and unfavorable foreign currency. Aerospace revenue increased strongly in the quarter due to market, pricing and content growth.

Sensing Solutions operating income was $84.2 million with operating margins of 27.6%. The decrease in segment operating margin was primarily due to the net margin impact of acquisitions and divestitures of 400 basis points. Excluding the foreign currency impact, Sensing Solutions operating margins would have remained the same at 27.6%.

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On Slide 9, corporate and other operating expenses not included in segment operating income were $81.5 million in the second quarter of 2023. Adjusted for charges excluded from our non-GAAP results, corporate and other costs were $68.1 million, a decrease from the prior year quarter primarily reflecting cost controls and lower incentive compensation. We expect to invest $60 million to $70 million in Megatrend-related research and development this year to design and develop differentiated solutions to address trends impacting our customers' businesses.

New business wins are a leading indicator of future outgrowth to market. Given the long cycle nature of our business, new business wins are tied to trends in our end markets and are best viewed on a multiyear basis. We expect to sign approximately $600 million to $800 million of new business wins this year, representing a 3-year average of nearly $800 million, a substantial increase from prior period averages.

Moving to Slide 10. Our capital deployment strategy and steadily improving returns to shareholders. As indicated by our improving return on investment capital of 9.8%, up 50 basis points from the end of 2022. We generated $68 million in free cash flow during the second quarter, up substantially from the prior year period and $371 million in free cash flow over the last 12 months, representing 65% conversion of adjusted net income.

For the full year 2023, we expect free cash flow conversion to be approximately 75% of adjusted net income, consistent with Sensata's long-term average. Capital expenditures are expected to be in the range of $170 million to $180 million for 2023. We paid down the balance of our outstanding variable rate term loan during the second quarter. Our net leverage ratio was 3.2x at the end of June 2023. And we expect this to decline to below 2.5x by the end of 2025, primarily through strong free cash flow generation.

During the quarter, we returned $25 million to shareholders in the form of share repurchases. In addition, we recently announced our Q3 quarterly dividend of $0.12 per share that is expected to be paid on August 23 to shareholders of record on August 9. We are providing financial guidance for the third quarter of 2023, as shown on Slide 11.

Our expectations are based upon the end market growth outlook shown on the right side of this page. We are aligned with IHS estimates for automotive production on a Sensata revenue-weighted basis. Foreign exchange represents an expected $6 million headwind to revenue, a 90 basis point headwind to adjusted operating margin and a $0.03 headwind to adjusted EPS in the third quarter. Excluding the impact of FX, adjusted operating income margin expectations for the third quarter represents a 60 basis point improvement from the prior year period. Our current fill rate is approximately 90% of the revenue guidance midpoint for the third quarter. This is consistent with fill levels we experienced pre-pandemic, and represent a return to normalcy of customers' supply chain dynamics.

Looking to the full year 2023, we now expect foreign exchange to be a $49 million headwind to revenue and a $0.20 headwind to adjusted earnings per share given term exchange rates.

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

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

Thank you, Paul. Let me wrap up with a few key messages as outlined on Slide 12. Sensata's business, organizational model and growth strategy are strong, resilient and validated. As we deliver mission-critical, highly engineered solutions required by our customers. While end markets are expected to remain volatile due to inflation, higher interest rates, the risk of recession in various geographies and geopolitical events, Sensata's strong management team provides proven experience in navigating choppy markets. We continue to execute on our growth initiatives as we transform the business to focus on rapid growth opportunities across all the end markets we serve. We are making excellent progress in electrification as demonstrated by strong new business wins and significant revenue growth.

Our success in driving this transformation allows us to focus now on strengthening our financial returns through improved margins, stronger free cash flow and higher returns on invested capital. As shown by the examples I discussed today, we continue to innovate for our customers, solving their difficult engineering challenges in providing differentiated solutions to a widening array of customers, while specifically leveraging our expanding electrification product set, solving mission-critical challenges enable Sensata to earn long-term customer trust as demonstrated by our expected $600 million to $800 million in new business wins this year and by delivering industry-leading margins for our shareholders.

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I'm pleased with our progress in delivering on Sensata's long-standing vision to help create a cleaner, safer, more electrified and connected world, not just for our customers' products, but also through our own operations, we strive to meaningfully contribute to a better world. We are making good progress on achieving our ESG targets, and I encourage you to read our latest sustainability report, which describes the long-term sustainability and success of the company for all of its stakeholders.

And finally, I'm very excited about sharing our innovation path and strategy and an investor event in New York City on September 27. You can find more details on our website regarding that event.

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. Keith, would you please introduce the first question?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And this morning's first question comes from Wamsi Mohan with Bank of America.

Wamsi Mohan - *BofA Securities, Research Division - MD in Americas Equity Research*

Jeff, your outgrowth in the first half is well below your long-term outgrowth. As you look over the next 12 months, can you talk about some of the puts and takes? And do you expect if inventory will still continue to be an overhang as it was 200 basis points in this quarter? And what are maybe some of the drivers that you think could possibly reverse over the next 12 months, particularly on outgrowth?

And if I could, one for Paul as well. On the margin front, you had very, very strong incremental margins in the quarter that you noted. How should we think about the sustainability of these very strong incremental margins?

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

Great. Thanks, Wamsi. So we discussed last quarter the expectation regarding outgrowth in the first half of this year given some well-publicized delays around some electrification platforms that we're on. But again, we want to emphasize outgrowth and NBOs for that matter as indicators of long-term success. So we have no concerns regarding our long-term outgrowth. We're very comfortable with the 400 to 600 range of outgrowth. The last year, last 12 months, it's been 535 basis points. The last 3 years, a little more than 3 years, it's been 735 basis points.

So I would encourage all to look at that as a long-term measure, not to look at an individual quarter in terms of the outgrowth there are puts and takes regarding the launches, mix of business and so forth that will impact that on our short-term measures. So I don't want it to confuse the view around secular long-term growth that we're very confident in, and we're sharing with investors the indicators around new business wins that will support that long term.

Regarding the inventory question, the one -- the couple of end markets where we're able to understand what inventory is or at least we have a model that we believe gives us a view into inventories around the automotive market during the second quarter, about $20 million on wound, that would lead us to believe there's still about $20 million. But it's getting to the point, Wamsi, where it's not a meaningful portion of inventory. We do really feel as though the order patterns from our customers and their inventory planning process is getting back to normal.

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I would credit that to not only changing market dynamics, but also how Sensata has served that market. If we are successful in delivering to our customers when they ask it, they'll get back to more normal order patterns and they won't carry extra inventory. So we're seeing that for sure, and I wouldn't expect it to be meaningful, but we'll continue to call out if we see inventory takeout in the system that we believe is happening or build in the system just to provide that level of transparency. But again, it's not a meaningful impact.

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

Wamsi, it's Paul. So as we said, our cost structure as it stands today has the capacity to serve more volume. And so you're seeing that in the incremental margins this quarter, where we're getting some better volumes. We're able to convert that at higher contribution rate. And for the foreseeable future, that's the kind of leverage I would expect until we get to a point where we need to start adding capacity and to support incremental growth. But that would be the expectation, at least for the foreseeable future in terms of what we should convert incremental volume at in that 35% to 40% range.

Operator

And the next question comes from Mark Delaney with Goldman Sachs.

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

Your revenue guidance assumes the auto end market is down 5% year-on-year in 3Q. I believe you said you're assuming something similar to IHS. But maybe you could elaborate a bit more on what you're seeing by end market from -- by region from your customers? And are you specifically trying to incorporate a strike in North America later in 3Q as part of your outlook?

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

Mark, thanks for that question, a couple of good points. So yes, the guide of $1 billion at our midpoint of guide would represent about a 5.5%, 5.8% down from Q2 2023. Now I'd note that -- that is, again, returning to more normal seasonality in the business. So if you look back to 2018 and '19, we saw a 4% to 6% decline from Q2 to Q3 associated with normal seasonality. So that is again another indicator of us regarding more normal patterns in terms of the business. That's been anything but normal over the last several years. And so I would view that decline from Q2 to Q3 as more normal.

And also down 2% from Q3 of last year, where that's coming from is market, right? So it's -- our market estimation across all markets is down 5.5%, third quarter of last year to third quarter of this year. We also have about a 60 basis point headwind associated with foreign exchange. So that's the driving factor obviously around the overall expectation regarding revenue down year-over-year on a quarter basis.

Regarding individual markets, as we indicated, we're right now on top of IHS in terms of production levels. They're forecasting auto to be down about 4%. And so we're down 5% when we waited for our impact associated with our business and the mix of our business, but pretty much in line with that. And what we're seeing is on a year-over-year basis, HVOR recovering a couple hundred basis points arrow going up 4% or 5%.

And then industrial, which is a very broad, diversified industrial market down dramatically. And I think the best indicators of that are around PMI across the world. Remember, we have some concentration there on HVAC, major home appliance, lighting, industrial lighting. And so that's continued down consistent actually with where we were in the second quarter. So hopefully, that provides a little bit more color for you.

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

Yes, that's helpful. I mean, and then just specifically around the potential UAW strike in North America, I mean is that something you try to incorporate it all within the range of guidance? Or just any more color on how you're thinking about that potential headwind in 3Q, if that does, in fact, come to fruition?

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

Yes. Great. Thank you. [Forgot] that one. So we are obviously keeping a very close eye on that. Our -- the indications that we hear from our customers is that a potential for more of a late Q3 or early Q4 impact. We are not seeing anything associated with order patterns that would suggest that anybody is preparing for that, although I think everybody is watching it very closely. And it is not contemplated in our guide.

And so obviously, if there is a nearer-term impact associated with that, then we'll -- the impact on our revenue will be commensurate with the impact on overall production levels that are -- that result from anything on that. So we were hoping for a positive outcome on that, but we're watching it very closely, but it's not contemplated in our $1 billion midpoint of guide range.

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

Thanks, Mark, for the question.

Operator

And the next question comes from Matt Sheerin with Stifel.

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

Yes. I'm hoping you can update us on pricing trends. It looks like it's been a tailwind for the last couple of quarters, less so in the coming quarter. So what's happening there in terms of pricing, particularly in the auto market?

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

So we continue to get positive pricing. It continues to more than offset the inflationary conditions around material prices that we've been experiencing for the last couple of years. So it continues to be a positive to revenue into profitability. Now we are now going to start comparing to more difficult comps. So the absolute increase quarter-over-quarter will be more challenging, but we're still positive on the pricing side.

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

Okay. Great. And Jeff, could you update us on insights, the telematics business? I know you made a lot of investments there. Could you give us an update on the business and the traction you're seeing?

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

Yes, absolutely. So remember that the premise here is that the telematics ecosystem broadly, logistics and supply chains benefit from more information. It makes their systems and their process more efficient and safe. And we have a lot of sensors that can bring data to that. Our acquisitions have been around collecting that sensor data on equipped and getting it to a cloud, in some instances, analyzing it and feeding it to customer fleet management systems.

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Continued positive trends in terms of what we see in terms of the opportunity there. But the reality is it's a $180 million business. It's going to grow very nicely, but it's become increasingly clear as a company that our future is electrification. We'll continue to focus on insights as we will continue to focus on safe and efficient applications in other powertrains but the future in terms of the trend and the acceleration of the trend associated with electrification is the area that we really need to be investing.

Our Megatrend investments have been disproportionately in the electrification area for some time now, and we'll continue to invest in insights as a growth vector, but electrification is the future of the company given where our customers are going.

Operator

The next question comes from Christopher Glynn with Oppenheimer.

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

Any comments or expectations, aspirations around the market capture you see Sensata able to harness for the Compact Power 5?

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

So on the inverter side, is that what you're referring to, Chris?

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

Yes, Jeff.

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

Yes. So recall last July, we acquired Dynapower, which was an industrial-grade inverter converter business serving that market. The business has performed very well, and we're really excited about the opportunity here associated with these new product launches that will really play well in terms of the overall market. It is a large market. There are some very niche areas that Dynapower is focused on associated with defense-related application but also hydrogen and other applications where we have targeted as being meaningful opportunities for us.

And I think if you follow sort of the trends associated with renewable energy, those are areas that will continue to see very strong investment from governments around the world. So we feel great about that, and we're going to continue to make sure that we execute in the market to bring that. This is part of our electrification strategy. I think that most tend to think of Sensata as a component play with OEMs, this is building on our view that with the electrification of all this equipment, there will need to be significant and considerable investment around grid hardening associated with the global infrastructure and Dynapower as well as, if you recall, lithium balance around battery management and other applications, that's our play in that area. And so we're feeling really positive about it.

Operator

And the next question comes from Luke Junk with Baird.

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

I just want to circle back on auto trends. And if you could just maybe help us understand the magnitude, at least on a relative basis of the auto headwinds you saw this quarter. So I'm thinking channel inventory destocking, you called that out as 200 bps overall. And maybe if you could

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comment on auto specifically plus the adverse mix and launch delays. Are those latter to similar? Or is there one of those factors that's having a more meaningful impact? And then as we look to 3Q and beyond, just how sticky each of those might or might not be?

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

Yes, absolutely. So we're not anticipating more channel destocking in our guide right now. So it's largely driven by the overall market. IHS forecast production to be down 4% in the third quarter versus third quarter of last year. That's going to come largely in China. So China is expected to be the one that's down the most. And so we're pretty much mirroring the impact associated with that. So that's the big driver in terms of really auto decline year-over-year and quarter-over-quarter, but also the company, given the fact that 50% of our business is automotive. So that's where we're seeing the largest impact on that book.

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

Just if I could clarify the adverse mix and the launch delays, to what extent are those reflected or not reflected in the third quarter outlook, Jeff?

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

They're absolutely reflected in the guide. We're comfortable with being able to stay within that 400 to 600 range in the last 12 months, but we know that some of that mix will continue to be a drag to the in-quarter overall outgrowth range. But remember, when that -- when those launches come back, that will be a pickup range. So if something pushes out of a quarter or out of a first half of the year eventually, our customers will need to pick that up, and that will overlap other opportunities that we are also anticipating. So it's not lost revenue. It's just deferred revenue that we have to contemplate in the overall guide. It will start to pick up in the second half of the year, much like it did from first quarter to second quarter. But we continue to see some delays on that front.

Operator

And the next question comes from (inaudible) with Evercore.

Unidentified Analyst

So I just wanted to ask about the row to 21% margins. And I know it's a longer-term target, but -- just wanted to understand what the biggest levers will be to get there from the current 19%. I know you guys mentioned volume last time, but any incremental information would be great. And I also wanted to ask you guys whether you're seeing any ease from commodity [and freight] costs coming down, which might be a tailwind.

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

Let me test the second part of that.

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

Commodity prices...

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

So I guess there's 2 things. One, we've been very prescriptive about the impact that currency is having year-over-year for benchmarking ourselves to a 21% margin that we've demonstrated in the past. If you adjust for currency, with 110 basis points headwind in the second quarter. And then just to be consistent with what we've done in the past, volume will be the largest driver of our margin increase over time. We're -- I think executing well on the pricing inflation dynamic. We're managing our cost structure very efficiently as the volumes start to come back, particularly in businesses like our industrial business, we'll see very, very significant incremental margins, as I mentioned earlier, that would be the thing that would drive us towards the 21%.

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

Yes. Just adding a little bit to what Paul said, I mean, I don't want to go -- I don't want to be missed that our third quarter guide would be in the 20s on a constant currency basis. And so although volume has the biggest variable impact on margins, foreign exchange is a meaningful impact on the margin profile of the business, which obviously is way outside of our control.

On the supply chain side, we're starting to -- we talked about the fact that we're starting to see supply chain challenges date considerably. And I would say that's pretty broad-based. Remember, though, that we have long-term engagement with our customers, we, therefore, have long-term structure with our supply chain.

So when we see supply chains normalize, that doesn't result in immediate impact in terms of pricing on the supply side, but it's something that we do extraordinarily well. We've demonstrated over decades that once we get to a more normalized operating environment, we can continue to show significant productivity in terms of our overall cost structure that will drive margin profile in the business.

We've been over the last 3 years in an environment where we've been challenged on that and it's completely been turned upside down what has been productivity year-over-year has been inflation year-over-year. And so in 2023, we're anticipating continued inflation on our COGS cost structure, but hopefully, we'll start to bend that cost curve as we go into '24 and '25 to get back to a more normal business model of productivity quarter-over-quarter and year-over-year. Thanks for the question.

Operator

The next question comes from Shreyas Patil with Wolfe Research.

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

Yes, maybe just following up on one of the other questions earlier. So Q3, you're guiding to 20% margin ex currency. We are seeing auto production improving some of the industrial end market headwinds that you're experiencing at the moment are potentially going to moderate as we look out to next year.

And so clearly, the volume should be a tailwind as you get back to 21% margin. But just maybe on this topic of supply chain, how do we think about when that starts to benefit the business? And are there any other puts and takes to think about as we look towards that 21% margin level?

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

Yes. So I'll take a crack head and Paul, you can add and correct me where I get it wrong. But -- we're starting -- the impact in terms of cost structure associated with inflation and what would normally be productivity for us has been improving, right? So if you look back to 2021, '22, where it was a very significant impact in terms of negative productivity in our cost structure. That's coming down at '23. And as I had mentioned to the prior question, we would expect that to continue to improve as we go into 2024.

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The volume in Q3 specifically is down pretty dramatically, right? So what we're seeing from a margin standpoint, constant currency will be at the 20%, right? So that shows improvement. That's with more foreign exchange headwind and with a decline in overall margin -- or excuse me, a decline in overall volume, which impacts margin. So listen, we're going to continue to aim towards the target profitability that we've identified. But given the environment that we're working in, associated with the volume decline, second quarter to third quarter and also the margin headwind we experienced associated with foreign exchange, we are marching toward the outcome that we've aimed for just it's taking longer given the other factors that we've talked about.

Operator

And the next question comes from Joe Giordano with JD (sic) [TD] Cowen.

Joseph Craig Giordano - *TD Cowen, Research Division - MD & Senior Analyst*

Can you talk about China specifically in the quarter? I know last quarter, like the mix was unfavorable given where the production was coming from. And I know this quarter, Tesla had a big production in China. So can you talk about how that looked and what you guys did? And maybe comment about the structural dynamics in China and like how you see that playing out, like who's going to take share and like what the opportunity is for you at those players?

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

Yes, absolutely. So I think the folks know that we had planned a trip to China, we were there in May. We talked about that a little bit in some other venues associated with investor calls or conferences and so forth. That was the first time that we were there as a management team in 3 years. China has always been fast. That has accelerated during periods of COVID. So I would say that maintaining our presence there is critically important, continuing to accelerate our pace of change with those customers is incredibly important. The Chinese companies like BYD, as an example, have gone from aspirations to win in the China market to aspirations to win in the global market. So engaging with those customers is incredibly for us as a company -- as a global company.

And we have good relationships there. BYD tends to be fairly vertically integrated, but they have a desire to work with multinational companies as they aspire to grow outside of regions. So engagement with our customers in China continues to be important. We're seeing some really good success. You know how our business has grown there, and we'll continue to focus on it.

Specific to an element of in China, I would say they're not growing right now, right? They're not growing dramatically, and that's inconsistent with where things have been over the last decade where we saw very strong growth in China. So overall, the market isn't growing. The government is doing a lot to try to convert from a more government-stimulated economy to consumer, the challenges that consumers are spending all their money on travel because they were cooped up for 3 years as opposed to buying durable goods. And products that our products would go into. So we're seeing weakness in the overall China market as a result of their economy and what's going on there.

And one other point that I would bring up, which we talked about last call is the pivot in the automotive market from local to multinational. That's sort of stabilized around the 47% rate. So if you were to look at Q2 of last year, the multinationals had 51% market share this year, they have 47%. That 47% is consistent with where it was in the first quarter of this year.

Now there was more of an impact in the first quarter because first quarter of '22, they had 54% market share. So there was a big decline from 54% to 47%, but it's stable -- it seems to have stabilized around 47%. Our modeling, which suggested there is a couple of hundred basis points of continued erosion there, which will have an impact on our business, but we don't see it going to 0. It's a desire to [buy] electric vehicles, given mandates associated with the license plate issuance. It's a lot easier to get a license plate in China for an electric vehicle than it is a combustion engine. And therefore, consumers are buying electric vehicles, and they are just larger options, a bigger number of options on electric vehicles and local brands versus multinational. So hopefully, that adds some color and provide some help to you.

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Joseph Craig Giordano - *TD Cowen, Research Division - MD & Senior Analyst*

It does. And just...

Operator

And the next question comes from Samik Chatterjee with JPMorgan.

Unidentified Analyst

This is (inaudible) McMillan on behalf of Samik Chatterjee. So I just wanted to touch on electrification a little bit more. Can you talk about how Sensata is thinking of investing in electrification opportunities in nonautomotive end markets. To the extent will this $2 billion of electrification revenue target be associated with electrification opportunities in these places?

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

Yes. Thanks for the question because it's -- I think it is a little bit misunderstood. We think of electrification very holistically. And only about half of our $2 billion target for 2026 will come from the light vehicle automotive market. There will be other areas that we will continue to play, and we're seeing very significant success in terms of new business wins, but also growth, right? So you think of electrification in the broader heavy vehicle market, think of electrification in terms of charging infrastructure for electric vehicles and broader industrial applications as well as what we talked about earlier, I think we got a question from Chris on Dynapower and the inverter market. So all of this electrification will require hardening of the grid. It doesn't do the environment any good if we switch to electrification and we generate electric power with gas or other greenhouse gas emitting applications.

So the move towards renewable energy is definitely an area where we're investing that we'll see the other half of the $1 billion come from across all of those other end markets outside of light vehicle. And great progress. We've talked about the fact last year of our $1 billion of new business win 70% of them were in the area of electrification. And we're seeing a similar trend in terms of mix of the new business wins this year versus where we were last year. So that's the good success in market associated with the capabilities we've developed.

Operator

And the next question comes from Chris Snyder with UBS.

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

So I understand the FX impact, but are margins facing the underlying business proving a bit more significant than you would have thought 12 months ago because when we look at the Q3 guide and we take the high end, even if we add back the FX impact, it doesn't seem to show much year-on-year margin improvement for the underlying operations despite all the actions over the last year to try to get these margins higher?

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

I would have to say that the improvement in the margin is coming largely from the core operations of the business. There is some improvement as we go from Q2 to Q3 in terms of we mix up, particularly in our Clean Energy segment. But largely, this is around executing on driving pricing about the inflationary costs for experience in controlling our costs, getting better throughput through the manufacturing sites, managing the inflation pressures on labor with increased automation, all those things are driving the improved margins. So it is all really fundamental blocking

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and tackling, the things that we do really well in terms of driving cost out of the business. And as -- like I said before, as the volumes start to improve, we will see significant incremental margins.

And the other thing that I would call out is our Industrial business, which is one of our most profitable, is down significantly year-over-year this year due to weak end markets. We talked about the weak PMI, that's driving a contraction in that end market. And when that market comes back, we'll see significant volume improvement and margin improvement.

Operator

And this does conclude our question and answer session. I would like to turn the floor now to Jacob Sayer for any closing comments.

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

Thank you, Keith. I'd like to thank everyone for joining us this morning. Sensata will be participating in the Goldman Sachs Technology Investor Conference on September 5 out in San Francisco. As Jeff mentioned, we'll also be hosting an investor event the morning of September 27 in New York City. This will be held both in person and virtually. Registration for that event is now open, and the link can be found on our Investor Relations website under Events.

We look forward to seeing you at one of those events or on our third quarter earnings call at the end of October. Thanks for joining us this morning and for your interest in Sensata. Keith, you can now end the call.

Operator

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

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