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Allison Transmission Holdings, Inc. (ALSN)

Q3 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. Thank you for standing by. Welcome to Allison Transmission's Third Quarter 2024 Earnings Conference Call. My name is Kevin and I'll be your conference call operator today. At this time, all participants are in a listen-only mode. After prepared remarks, Allison Transmission executives will conduct a question-and-answer session and conference call participants will be given instructions at that time. As a reminder, this conference call is being recorded.

I would now like turn the conference call over to Jackie Bolles, Executive Director of Treasury and Investor Relations. Please go ahead, Jackie.

Jacalyn C. Bolles
Executive Director-Treasury & Investor Relations, Allison Transmission Holdings, Inc.

Thank you, Kevin. Good afternoon and thank you for joining us for our third quarter 2024 earnings conference call.

With me this afternoon are Dave Graziosi, our Chair and Chief Executive Officer; and Fred Bohley, our Chief Operating Officer, Chief Financial Officer and Treasurer.

As a reminder, this conference call webcast and this afternoon's presentation are available on the Investor Relations section of allisontransmission.com. A replay of this call will be available through November 12.

As noted on slide 2 of the presentation, many of our remarks today contain forward-looking statements based on current expectations. These forward-looking statements are subject to known and unknown risks, including those set forth in our third quarter 2024 earnings press release and our Annual Report on Form 10-K for the year ended December 31, 2023, as well as other general economic factors. Should one or more of these risks or uncertainties materialize, or should underlying assumptions or estimates prove incorrect, actual results may vary materially from those that we express today.

In addition, as noted on slide 3 of the presentation, some of our remarks today contain non-GAAP financial measures as defined by the SEC. You can find reconciliations of the non-GAAP financial measures to the most comparable GAAP measures attached as an appendix to the presentation and to our third quarter 2024 earnings press release.

Today's call is set to end at 5:45 PM Eastern Time. In order to maximize participation opportunities on the call, we'll take just one question from each analyst. Please turn to slide 4 of the presentation for the call agenda.

During today's call, Fred Bohley will review our third quarter 2024 financial performance and review updates to our full year 2024 guidance. Dave will close with an update on recent announcements across our business, prior to commencing the Q&A.

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

G. Frederick Bohley

Chief Operating Officer, Chief Financial Officer & Treasurer, Allison Transmission Holdings, Inc.

Thank you, Jackie. Good afternoon and thank you for joining us. As we progress through 2024, demand for Class 8 vocational vehicles continues to drive notable performance in Allison's North America On-Highway end market, leading to record results for the business as a whole. I would like to take a moment to thank our team for the combined efforts, working diligently to meet the unprecedented demand we are seeing for our 3000 Series and 4000 Series products in North America, while continuing to work toward the realization of our $100 million incremental annual revenue opportunity in our Defense end market, as well as drive our growth objectives Outside North America to capitalize on increased adoption of automatic transmissions.

Please turn to slide 5 of the presentation for the Q3 2024 performance summary. Year-over-year net sales increased 12% from the same period in 2023 to a record of $824 million. The increase in year-over-year results was led by a 22% increase in the North American On-Highway end market, principally driven by strength in demand for Class 8 vocational vehicles and medium-duty trucks and price increases on certain products.

Year-over-year net sales were further improved by a 23% increase in our Defense end market. The increase was principally driven by increased demand for Tracked vehicle applications. And finally, year-over-year results were improved by a record third quarter in our Outside North American On-Highway end market. The increase in net sales in the Outside North America On-Highway end market was principally driven by higher demand in Asia and price increases on certain products, partially offset by lower demand in Europe.

Gross profit for the quarter was $396 million, an increase of $39 million from $357 million for the same period in 2023. The increase in gross profit was principally driven by increased net sales and price increases on certain products, partially offset by higher manufacturing expense.

Net income for the quarter was $200 million, an increase of $42 million or 27% from the same period in 2023. The increase was principally driven by higher gross profit and lower interest expense, net.

Adjusted EBITDA for the quarter was $305 million, compared to $267 million for the same period in 2023. The increase in adjusted EBITDA was principally driven by higher gross profit. Diluted earnings per share increased 29% year-over-year to an all-time quarterly record of $2.27. The increase was driven by higher net income and lower total shares outstanding. A detailed overview of our net sales by end market and Q3 2024 financial performance can be found on slides 6 and 7 of the presentation.

Please turn to slide 8 of the presentation for the Q3 2024 cash flow performance summary. Adjusted free cash flow for the quarter was $210 million compared to $182 million for the same period in 2023. The increase was principally driven by higher gross profit, partially offset by higher operating working capital funding requirements and increased cash taxes and capital expenditures.

During the third quarter, we paid a dividend of $0.25 per share and repurchased over $50 million of our common stock. We ended the quarter with a net leverage ratio of 1.4 times, $788 million of cash, and $745 million of available revolving credit facility commitments. In addition, we continue to maintain a flexible, long-dated, and covenant-light debt structure.

Please turn to slide 9 of the presentation for the update to our 2024 guidance. As a result of the ongoing strength in the North American On-Highway end market, we are raising our full year guidance midpoints for revenue, earnings, and cash flow. Allison expects net sales to be in the range of $3,135 million to $3,215 million.

In addition to the Allison's 2024 net sales guidance, we anticipate net income in the range of $675 million to $725 million, adjusted EBITDA in the range of $1,115 million to $1,175 million, net cash provided by operating activities in the range of $740 million to $800 million, capital expenditures in the range of $135 million to $145 million, and adjusted free cash flow in the range of $605 million to $655 million.

Thank you. And I'll now turn the call over to Dave for an update on recent announcements across our business.

David S. Graziosi

Chair & Chief Executive Officer, Allison Transmission Holdings, Inc.

Thank you, Fred. Allison continues to see robust demand for our on-highway products, particularly our 3000 Series and 4000 Series fully automatic transmissions due to unprecedented Class 8 vocational vehicle demand stemming from sustained infrastructure spending in North America. In order to meet this elevated demand throughout the year, we have made investments in our supply chain and operations to not only manage capacity, but also improve manufacturing throughput.

Last week, we announced further plans for long-term sustainable growth and global capacity increases for our on-highway products through investment in our Chennai, India facility. Opening in 2010, our Chennai, India facility serves as the headquarters in the region, expanding our presence while initially fabricating parts to support global production of our 1000 Series and 2000 Series on-highway products.

After demonstrating the ability to meet Allison's best-in-class manufacturing practices, the facility expanded capabilities to assemble our 1000 Series and 2000 Series transmissions in 2012, while relying on components provided from our Indianapolis sourcing supply chain. We are excited to invest to nearly double the manufacturing footprint of the India facility, increasing fabrication capabilities for components of our 3000 Series and 4000 Series on-highway products, giving us the ability to tailor our global production to meet regional demand.

Our investment of over $100 million will be spread over the next few years, with nearly half of that total project spend expected to occur in 2025. As operations begin in 2026 and ramp up to full production in 2027, this investment will support our long-term growth objectives in the Outside North America regions, raising our global capacity and offering operational cost savings.

Through this investment, our global manufacturing operations will return to optimized levels of production, offering cost savings through efficiency gains, while increasing Allison's ability to meet the future demand for our on-highway products driven by the continued global adoption of automatic transmissions. We look forward to providing further updates as the project progresses.

In support of our Wide Body Dump initiative, representing $100 million of incremental annual revenue opportunity during the quarter, we announced a strategic partnership and executed a memorandum of understanding with LiuGong, a top tier global construction equipment manufacturer. The MOU signing took place in Indonesia as part of a customer ride-and-drive event, showcasing LiuGong's latest 70-ton Wide Body Dump Truck equipped with Allison's innovative 4800 Wide Body Dump Series transmission.

Our longstanding partnership with LiuGong has been instrumental in our success in the global mining sector, with this MOU promising continued collaboration and innovation as we progress towards our incremental annual growth revenue target through share gains and market expansion.

Also, in our Outside North America On-Highway end market, we recently announced our collaboration with Ashok Leyland, one of India's leading commercial vehicle manufacturers, to introduce the first low-floor city buses equipped with fully automatic transmissions in the Southern India market.

Allison's Torqmatic Series transmissions will equip the 12-meter diesel buses, which are specially designed to accommodate passengers with disabilities. The Allison-equipped buses will replace buses currently equipped with manual transmissions, advancing transportation in the region, and showcasing our efforts to lead the transition to automaticity outside North America.

Further driving our growth in Outside North America On-Highway end market is our wheeled defense business. As a reminder, the wheeled portion of our Defense business utilizes variants of our conventional on-highway products with revenue from international customers flowing through our Outside North America On-Highway end market.

Last week, we highlighted numerous releases which will support continued growth as a result of our strategic partnerships with vehicle manufacturers to support wheeled defense programs internationally using Allison's Specialty Series on-highway transmissions. To start, variants of our 4000 Series fully automatic transmissions were chosen for the British Ministry of Defence Boxer armored vehicle program.

The German Federal Armored Forces will also begin receiving Boxer vehicles equipped with Allison fully automatic transmissions starting in 2025. This is in addition to over 700 Boxer vehicles that have been delivered in recent years to countries including Australia, Lithuania and the Netherlands. The Canadian Department of National Defence and the Romanian Ministry of Defence will also be receiving wheeled defense vehicles equipped with the 4000 Series variant.

In Poland, a new contract was signed for procurement of Light Armored Reconnaissance Carriers equipped with a variant of Allison's 3000 Series fully automatic transmission. Deliveries will span over the next decade to 2035.

And finally, the United Kingdom Ministry of Defence has placed an order for high mobility trucks that will utilize a variant of Allison's 2000 Series fully automatic transmission.

As demonstrated by these releases, Allison has made significant strides in the global defense market with the achievement of key program wins. We look forward to further growth across the defense industry as we leverage our commercial vehicle expertise and relationship with OEMs, along with decades of proven reliability and durability to offer a wide range of propulsion solutions that meet the diverse application requirements for tactical wheeled vehicles.

Finally, as our end markets evolve, we remain committed to offering a portfolio of products designed to meet the needs of customers and industry regulations, regardless of technology and fuel source. Allison fully automatic transmissions are fuel agnostic, offering optimal integration with any fuel source, including gasoline, natural gas, propane and hydrogen, delivering durability and reliable performance to strengthen sustainability initiatives without sacrificing fleet productivity and efficiency.

To compensate for the lower power and slower engine response associated with alternative fuels, Allison's powershift technology and torque converter significantly improves startability, drivability and overall productivity, particularly as compared to competitive manual and automated manual transmissions.

In late August, we were pleased to announce that GLS, a global shipping leader, successfully completed 30,000 kilometers in its evaluation of the Allison-equipped Hyundai Xcient hydrogen fuel cell truck. Since late 2023, GLS Germany has used the hydrogen fuel cell truck equipped with Allison's 4000 Series fully automatic transmission to deliver packages in the greater Cologne area. Additionally, since March 2024, the truck has been used for long-distance trips between Cologne and Mannheim.

Allison's patented torque converter multiplies the drive motor's torque at startup, allowing the vehicle to operate with a smaller and less powerful drive motor, maximizing range and efficiency and helping to reduce vehicle costs. This pioneering integration exemplifies Allison's alternative fuel advantage and is a further step in the testing of environmentally friendly propulsion technologies.

Furthering our capabilities with hydrogen as a fuel source, we are pleased to announce our 4000 Series fully automatic transmission was also integrated into a Class 8 truck equipped with a Hydrogen Internal Combustion Engine that was displayed by Southwest Research Institute at COMVEC in September. The integration of the Allison's 4000 Series in the Hydrogen Internal Combustion Engine vehicle demonstrates the critical role internal combustion engine powertrain solutions can and will play in moving the industry closer to ultra-low emissions.

As our industry approaches 2027, there will be transitions in technologies for compliance under the EPA's Phase 3 emissions regulations. Announced during the quarter, we recently collaborated with Cummins to integrate and certify the Cummins B-Series engines with our Allison eGen Flex electric hybrid propulsion solution system for the transit bus market. The integration will meet EPA's Phase 3 requirements for – while providing a reliable low emission propulsion solution in 2027 and beyond.

Also, in pursuit of compliance to emission standards, we were pleased to announce an uprate to our B400 and B3400 xFE fully automatic transmissions. As the non-articulated bus industry transitions to the Cummins X10 engine in order to meet the EPA's Phase 3 requirements, the increased ratings for our B400 and B3400 xFE models will enable fleets to continue specifying Allison products as the propulsion solution of choice.

As shown by these integrations, collaborations and technology advancements, Allison is dedicated to offering products which comply with upcoming emissions regulations, while continuing to deliver differentiated value that supports our customers' operational and sustainability goals.

In summary, Allison's third quarter results demonstrate not only the robust demand in our core end markets, but also our long-term plans for growth as we invest in our manufacturing operations in our product portfolio. Our growth opportunities and investments highlight Allison's commitment to providing a diverse array of propulsion solutions that contribute to a reliable, more sustainable future in transportation.

This concludes our prepared remarks. Kevin, please open the call for questions.

QUESTION AND ANSWER SECTION

Operator: Certainly, we'll now be conducting a question-and-answer session. [Operator Instructions] Our first question is coming from Ian Zaffino from Oppenheimer. Your line is now live.

Ian Zaffino
Analyst, Oppenheimer & Co., Inc.
Q

Hi. Great. Thank you very much. Very good quarter. Just a quick question on the pricing outlook for next year. I know we're kind of getting into – towards the end of the year. How are discussions going there and what type of magnitude do we think we're going to expect? Does the environment change any of that thinking, one way or the other? Thanks.

G. Frederick Bohley
Chief Operating Officer, Chief Financial Officer & Treasurer, Allison Transmission Holdings, Inc.
A

Thanks, Ian. This is Fred. I think as you're aware, about 60% of revenue in North America On-Highway LTAs are coming due and we're in the middle of negotiating these currently. As we've talked about in the past, we continue to deliver a significant amount of value to the end market. Our fully automatics allow the commercial vehicles to operate more efficiently.

So the type of things that we're more efficient and we save on have continued to inflate up. Overall vehicle cost is up. Cost of drivers are up. Cost of maintaining equipment is up. So all the advantages that our fully automatic deliver have continued to elevate. And so as we sit here right now, definitely, feel well positioned. We're delivering a significant amount of value. There is very, very strong demand for our product. And we'll continue the negotiations and anticipate most of them concluding probably toward the later half of Q4.

Ian Zaffino
Analyst, Oppenheimer & Co., Inc.
Q

Okay. Thank you very much.

Operator: Thank you. Next question is coming from Rob Wertheimer from Melius Research. Your line is now live.

Rob Wertheimer
Analyst, Melius Research LLC
Q

Good evening. I am sorry to ignore all the good news on announcements and trials and everything else in operations that you talked about. I wanted to focus just on the balance sheet, use of cash, and so on. I mean, you guys have been super clear over the years, you've been very aggressive in buying back shares. I think if I'm not mistaken, your cash balance is something like 8% or 9% of your market cap, and your maturities, I think, are out to 2027. So, just curious if you're pausing for any reason on aggressiveness on share buyback, if there's anything being contemplated or how to think about that. Thank you.

G. Frederick Bohley
Chief Operating Officer, Chief Financial Officer & Treasurer, Allison Transmission Holdings, Inc.

A

Hi, Rob. It's Fred. I mean, as you mentioned, I mean, our capital allocation priorities are pretty clear. I mean, it's first, funding organic revenue and earnings growth. And you see that with the recent announcement we made relative to manufacturing in India. Obviously, we talked about a lot going on in the product development space. Certainly, we've done some acquisitions and continue to look proactively at that. But our primary focus has been returning capital to shareholders.

63% of shares repurchased since we became a public company. We increased the dividend five consecutive years, bringing it from $0.15 per share per quarter to $0.25 per share per quarter. It's certainly factual that we're holding a little higher cash balance than we have historically. We still are earning a very appropriate return on that. But long-term goal is to follow our capital allocation priorities and fund the business and ultimately return the excess cash to shareholders.

Rob Wertheimer
Analyst, Melius Research LLC

Q

The manufacturing capital needs don't seem to be all that large versus what you have. So I assume it's more timing differential, maybe you have an acquisition you're not going to talk about, but more timing differential on spending that cash. I mean, do you intend to keep a higher than average balance long term, do you think? And I'll stop there. Thanks.

G. Frederick Bohley
Chief Operating Officer, Chief Financial Officer & Treasurer, Allison Transmission Holdings, Inc.

A

No, I think it really is timing of returning cash to shareholders, Rob.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Perfect. Thank you.

Operator: Thank you. Next question today is coming from Tim Thein from Raymond James. Your line is now live.

Tim W. Thein
Analyst, Raymond James & Associates, Inc.

Q

Thank you. Good afternoon. I just wanted to come back to the $400 million growth opportunity or outgrowth opportunity you guys have outlined for some time. And it's hard to see externally where you're falling on that. But you talk about – I mean, and maybe Defense is where we've seen a little bit more traction. But, I mean, just kind of those four drivers that you talked about, I mean, where are we in terms of marching towards that? Is it in any sort of framework as to how to think about a potential timeline? I know it was maybe purposefully or intentionally nebulous in terms of the timing when you set it. But I'm just curious as to come back to that as to how we're moving towards those targets or goals. Thank you.

David S. Graziosi
Chair & Chief Executive Officer, Allison Transmission Holdings, Inc.

A

Tim, it's Dave. Let me just try to cover that off for you and I appreciate the question. So, from a growth initiative perspective, we really highlighted four things, Wide Body Mining Dump, FracTran, the Regional Haul Class 8 tractor day cab, and of course, Defense.

Starting with Defense, as you mentioned that one specifically, we continue to make very good progress there. I think you could tell by the prepared remarks, I think the team has done an excellent job, frankly, spreading our customer base outside of the US at this point. So, obviously, focused on working with allies, but we see – continue to see a tremendous amount of opportunity there.

In terms of our overall progress towards our target, that's probably one of the most advanced out of the four at this stage with, we believe, a fair bit of tailwind to achieve the balance of that growth target, if not more. So, as we discussed several times, the defense upcycle continues. So, we're receiving a fairly high level of inquiry. You'll also note that the product development work that we've done around the eGen Force, as well as variants of our other cross-drive products, continue to be received very well in the market. So, the focus there, the key will be some of the newer US sponsored programs, as well as a number of Outside North America initiatives.

Regional Haul Class 8 tractor day cab making, I think, decent progress there. Although I would tell you, market conditions, as you know, we've talked several times on our calls this year and frankly late last year, some of the softness that you're seeing in the tractor market is having an impact there in terms of just overall volume that's actually achievable at this stage. So, the team has done, I think, a very good job securing releases and driving it from a pull perspective with various fleets. But that market will – largely, the outcome there will be tied to overall demand in terms of the tractor market recovering.

FracTran, as you know, was purpose-built and designed for hydraulic fracturing applications. As we've again said several times during the year on other calls, hydraulic frac right now in terms of overall CapEx is rather muted. Very disciplined approach by end users in terms of spend. At least the public comments, the most recent ones from some of those customers would certainly imply no significant recovery in terms of capital spending yet this year and quite possibly for 2025.

So very similar to Regional Haul Class 8 tractor, will be a function of the market in terms of overall demand. The testing that we are doing and some of the activity we have, we're very pleased with the performance of that particular technology. It's also allowing us to expand into some of the newer applications within hydraulic frac around different energy sources, et cetera. So I think the team has done a solid job there working with a number of core partners of ours.

And finally, with the Wide Body Mining Dump, beyond the prepared comments and some of the releases that we've talked about this year, that particular initiative, I would describe, is making very solid progress. Again, some of that being tied to market conditions where you're seeing a level of global demand, as you well know, a bit mixed. But despite those market conditions, the partnerships with the OEMs that we have, they've done quite well in terms of securing market positions throughout the world.

So we're very confident in ultimately achieving that as well as the other three initiatives. It's really just a function of time and broader market conditions there.

Tim W. Thein
Analyst, Raymond James & Associates, Inc.
Q

Understood. Thank you, Dave.

Operator: Thank you. Next question is coming from Angel Castillo from Morgan Stanley. Your line is now live.

Angel O. Castillo
Analyst, Morgan Stanley & Co. LLC
Q

Thanks, gentlemen, and appreciate you taking my question. I just wanted to touch base on the fourth quarter a little bit more. It seems like it's a pretty wide range in terms of the EBITDA implied of kind of 20% decline year-over-year to potentially flat. It seems like a pretty wide range. As you think about the level of visibility you have to the fourth quarter, I recognize last quarter or the last earnings call, you talked about holidays and some of those dynamics that impact your year-over-year as well as a kind of tough comp. But can you just help us understand maybe the range of outcomes? What are the assumptions that could result in a minus 20% year-over-year versus it being closer to flat at the top end?

G. Frederick Bohley
Chief Operating Officer, Chief Financial Officer & Treasurer, Allison Transmission Holdings, Inc.
A

Sure, Angel, this is Fred. And we've highlighted this a couple of quarters in a row, but I think it's really important to just think about six or seven fewer workdays for the OEMs to build. And this year, we've averaged $12 million, $13 million in revenue a day. So you play that out, our expectation is that they're not going to build at the levels they built the last couple of years. And they're probably going to go back to sort of the normal seasonality that we'd seen pre-pandemic, 2018, 2019, where Q4 would be soft. So that's really, at a starting point, driving where our midpoint guide is on a sequential basis from a revenue standpoint. And that's really just flowing through from an EBITDA standpoint.

As you look across, we've got engineering SG&A slightly elevated sequentially, but the biggest driver really is the top line and the type of margins that we make. So what would drive the performance higher is, clearly, with the OEMs attempt to work more days, basically working Saturdays or into the holidays. But at this point where they are relative to, I think, their total order boards and the softness that you're seeing across line-haul just makes this year stack up a little different than what we've seen in the last couple of years.

Angel O. Castillo
Analyst, Morgan Stanley & Co. LLC
Q

Very helpful. Thank you.

Operator: Thank you. Next question is coming from Tami Zakaria from JPMorgan. Your line is now live.

Tami Zakaria
Analyst, JPMorgan Securities LLC
Q

Hi. Afternoon. Very nice quarter. Two questions for you. The first one is about the facility investment in India. I think you mentioned capacity is doubling there. So when you ramp to full production in 2027, what kind of incremental volume do you expect versus what it is right now? I'm trying to understand the size of the incremental sales opportunity from this increased capacity in 2027.

David S. Graziosi
Chair & Chief Executive Officer, Allison Transmission Holdings, Inc.

A

Tami, good evening. It's Dave. I appreciate the question there. So, to be clear, when we talk about capacity expansion, we are doubling the manufacturing square footage in India. In terms of capacity, it's focused on our on-highway products, specifically around fabrication for our 3000 Series and 4000 Series products. That capability will allow us to, frankly, meet the growth demand that we're seeing for our – out of our facility in Hungary that assembles our 3000 Series and 4000 Series transmissions as well.

So, to answer your question, in terms of overall capacity, again, assuming an eight-hour shift schedule, a normal shift schedule, that capacity increase for on-highway products is approximately a 10% to plus or minus 20% increase. So, you can figure somewhere in that range of 10% to 20%, again, depending on availability for all components, et cetera. But we are not expanding capacity for assembly. It's expanding capacity for fabrication for demand outside North America.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Got it. Got it. Okay. That's very helpful. And my second question is, I think you mentioned unprecedented demand in vocational trucks right now. How do you see this demand playing out over the next few years? Investors often ask where we are in the vocational truck cycle. So, I'm curious, how would you answer that question? Where are we in the vocational truck upcycle?

David S. Graziosi
Chair & Chief Executive Officer, Allison Transmission Holdings, Inc.

A

Well, that's an excellent question and one I think a number of parties are contemplating. I would just tell you, we don't use the word unprecedented lightly. The amount of demand that we have seen throughout this year and frankly, it started, as you probably know, the second half of last year, some ramp up there. We have not heard anything from a market perspective, whether that be end users or OEMs sensing any level of pullback on overall demand.

As we've talked about on prior calls, you had a level of suppressed production because of COVID for a number of reasons. At the same time, you've had this enormous injection of capital into the market, driving demand for vocational products. So whether that be infrastructure spending, other investment initiatives and incentives, they are out there and driving demand.

So we are, again, seeing nothing at this point that would tell us that this is a near-term end in sight. I think, quite frankly, at least from the public comments of vehicle OEMs, I think they've indicated across the board very strong demand well into 2025.

On the back end of 2025, you also have this issue of, as you know, emissions changes for 2027 and what that potentially does as well in terms of just taking normal demand and accelerating some of that. As we mentioned on the July call, having said all of that, there is a bit of a governor in this entire process about how much higher it can go, at least when you look at it quarter-to-quarter, simply because many industry participants are operating at some level of max capacity right now, which is not long-term sustainable, frankly.

So you are – I think, naturally, have some level of limit or governor in how much higher it can go on an instantaneous basis. Therefore, one could conclude the cycle gets stretched out further simply because demand can't be currently met. You also have the other governor in the process, which is the amount of capacity that's out there in terms of bodybuilders and what those lead times are, and much of that is not really tied necessarily to material as much as it is just conversion, which is skilled labor availability, et cetera, which we've mentioned many times on our calls and one that we continue to see as a constraint throughout the industry.

Tami Zakaria
Analyst, JPMorgan Securities LLC

Q

Agreed. Wonderful. Thank you.

Operator: Thank you. Next question today is coming from Kyle Menges from Citigroup. Your line is now live.

Kyle Menges
Analyst, Citigroup Global Markets, Inc.

Q

Thanks. I was hoping if you could provide a little more insight into parts performance in the quarter. I noticed that for the first couple of quarters, you had been calling out North America as the area of weakness, but now it's turned to just globally seeing some weakness. So it would be helpful to understand which geographies potentially are still seeing some weakness or maybe some recovery and just how to think about parts into next year and what it would take to see parts growth next year and what geographies would be likely to drive that. Thank you.

G. Frederick Bohley
Chief Operating Officer, Chief Financial Officer & Treasurer, Allison Transmission Holdings, Inc.

A

Sure, Kyle. This is Fred. Really on a year-over-year basis, there wasn't significant movement from parts. When you think about where we are full year, certainly, the first half of 2023 was a pretty challenging comp coming into 2024. As we're looking at the balance of the year, Q4 could be down mildly sequentially.

And then as you look out into 2025, I think it's still going to be a fairly good year. You're sitting here, where 2024 is going to be your second best year on record next to 2023. It's also an end market where we've been able to achieve price as well. So, I think the outlook looks fairly robust rolling into 2025 at this point. But we don't see it returning to the H1 2023 level, because all that pent-up demand has really been satisfied at this point.

Kyle Menges
Analyst, Citigroup Global Markets, Inc.

Q

Helpful. Thank you.

Operator: Thank you. Next question is coming from Luke Junk from Baird. Your line is now live.

Luke L. Junk
Analyst, Robert W. Baird & Co., Inc.

Q

Good evening, everyone. Thanks for taking the question. Another capacity question for me, specific to Allison's capacity, and just hoping you can frame up the levers that you have to pull on throughput from here. Thinking specifically in North America, without adding materially to capacity, I guess, if I look through the lens of Defense this quarter, it seems like there might be some additional breathing room opportunity, and maybe if you could speak relative to potential pre-buy as we move through later next year into 2026 and just your ability to scale up without adding significantly to overhead, including maybe offloading some incremental volume into that capacity expansion in India as you move through the peak. Thank you.

David S. Graziosi
Chair & Chief Executive Officer, Allison Transmission Holdings, Inc.

A

Hi, Luke. It's Dave. Appreciate the question. So, in terms of capacity, as we mentioned, it's not only investment that Allison is doing internally for our own operations; we're also investing in our suppliers. So, it's been a fairly comprehensive program of initiatives throughout our supply base, as well as the internal that we've already talked about. I would certainly offer the comments in terms of what we prepared.

It's important to note, and I mentioned this briefly earlier, the industry is, specifically around North America On-Highway, for instance, running at very high rates, becomes a real challenge from a consumption of capital. So, between the pressure on labor, as well as just pressure on operations, it really requires a very diligent, industry-wide initiative around maintenance, et cetera. And when you're running at very elevated levels, it really is quite challenging.

So, we've, certainly throughout our capacity and capital investments, invested in – investing in upgrading our equipment as well as some level of automation to address, I think, your point about how you think about an overhead structure. But the fact remains is, as I said earlier, there are limits right now that we see in the industry. It still takes all the components to make the vehicle. So, there are certainly constraints. I do not believe that across the entire industry, there is a tremendous amount of motivation to increase capacity meaningfully above where it sits today, simply because it's not efficient. When you start breaking shift schedules, et cetera, as we mentioned before on calls, it becomes very inefficient.

The investments that we're making in India are part of the reason for that. A justification is to really relieve some of the pressure that we have throughout our operations and our suppliers. So to get back to what we referred to as lean capacity rate operations, which are more efficient by definition and experience, it also lends us to – or allows us to get back to that lean capacity rate faster than where we sit today. So, there are cost savings as well that will be realized from that investment.

In terms of Defense on the cross-drive side, we have significant capital plans being executed for our cross-drive facility. Some of that capital is actually funded by the US government. It's a contractor-owned, contractor-operated structure that leads us to or puts us in a position of having a relatively asset-light business there.

So, to your point on overhead or really structuring the operation, we staff it and structure it as efficiently as we can. However, the nature of those products generally do not lend themselves to a highly efficient operation simply because it's a low volume, batch type manufacturing. Our team over the years has really developed a manufacturing process and a system that allows for that type of variability in terms of volume.

We're also mitigating some of that, as to the earlier question on growth initiatives, to grow our Defense business, specifically in cross-drive to level out, if you will, production in that facility, which allows us to perform better, but also reduce the cost to the US government in terms of cost-plus type contracts. So, a lot of work going on there.

But overall, I think capacity, as Fred mentioned earlier, in terms of cap allocation, we are investing in growing the business organically, also heavily in terms of research, development, et cetera. So we would look at the business today as very well-funded and we just need to execute and get these growth initiatives further evolved in terms of market conditions.

Luke L. Junk
Analyst, Robert W. Baird & Co., Inc.

Q

Yeah. Thank you for all that, Dave. Appreciate it.

Operator: Thank you. Next question is coming from Jerry Revich from Goldman Sachs. Your line is now live.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Hi. Good afternoon and good evening. I'm wondering if I just ask two questions, one on EPA 2027 with the increase in trucks, you folks have a higher value proposition and higher cost trucks. So I'm wondering, can you comment on whether you have an opportunity to increase your penetration rates on any applications with EPA 2027 given that backdrop.

And then separately, just to continue the Class 8 straight truck conversation, can you just talk about your level of confidence in the sustainability of demand? Because we're down to 4.5 months of backlog. We have peaked at 10 months or 11 months. And so, I guess, when we've seen other capital goods product lines have supply outpace demand, what gives you confidence that we're not going to hit that same point here, as we look out three, four, five months, especially given where Class 8 straight inventories are?

David S. Graziosi
Chair & Chief Executive Officer, Allison Transmission Holdings, Inc.

A

Jerry, it's Dave. Appreciate the question. In terms of EPA 2027, I think it's fair to say there's still quite a few questions out there in terms of exactly how that's all going to be implemented. The position of the OEMs' portfolios, as you know, continues to evolve in reaction to that. We think of things in the context of we're always trying to grow our position in terms of penetration rates and focus on the areas, as Fred mentioned earlier, in terms of our value proposition.

So, to answer your question, I'm not sure penetration over the longer term is going to be necessarily impacted. I would say, to your point on vehicle values, I think it's fair to say that the current push on Class 8 straight truck in terms of vocational, we are certainly, I think, very much strongly demonstrating the value of our fully automatic technology in that space.

The team has done that for well over a decade or two at this point to reach the positions that we have. We continue to try to grow that. But overall, I think we're very pleased going into 2027 with the portfolio that we have. We're well aligned to work with at least what's been developed and I would say certainly presented to the market in terms of a number of different alternative energy sources, et cetera. So we feel very good about that.

And I'll let Fred cover that Class 8 straight truck question.

G. Frederick Bohley
Chief Operating Officer, Chief Financial Officer & Treasurer, Allison Transmission Holdings, Inc.

A

Hey, Jerry. I mean, it's – everything we see in here shows no signs of it slowing down. And the OEMs have been pretty clear, the demand for our product is clearly unprecedented. And we had last week ACT Research in here. One thing that they were highlighting was really where the stimulus programs are and still very early innings.

Thinking about the CHIPS Act, IRA, maybe only 20% in at this point, Infrastructure Investment and Jobs Act about 50% in. So there's still a significant amount of stimulus money in the US that's out there to ultimately be funded. So, it's obviously tough to predict and we've got the pre-buy potential in 2026 and maybe even into 2025.

I think to Dave's earlier comments, there is a, I think, a real question of how much higher can it go, because everybody in that vocational space is constrained at this point, component suppliers, bodybuilders, but the demand is clearly there with, I mean, just absolutely no signs of slowing down.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Thank you.

Operator: Thank you. We reached end of our question-and-answer session. I'd like to turn the floor back over to Dave for any further closing comments.

David S. Graziosi
Chair & Chief Executive Officer, Allison Transmission Holdings, Inc.

Thank you, Kevin, and thank you for your continued interest in Allison and for participating on today's call. Enjoy your evening.

Operator: Thank you. That does conclude today's teleconference. You may disconnect your line at this time and have a wonderful day. We thank you for your participation today.