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RTX.N - Raytheon Technologies Corp at Morgan Stanley Laguna Conference

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PRESENTATION

Kristine Tan Liwag - *Morgan Stanley, Research Division - Equity Analyst*

So thank you, everyone. So if we could get the countdown back at the screen. So we don't -- otherwise, we'll have Greg here all day, which may not be a bad thing. So we'll start this next session.

I'm Kristine Liwag, Head of Aerospace & Defense Research at Morgan Stanley. I'm very excited to have Greg Hayes, Chairman and CEO of Raytheon; and Neil Mitchill, CFO of Raytheon Technologies.

So before we start, I need to read a set of disclosures. I wish I could just record myself, I could play it now. For important disclosures, please see the Morgan Stanley Research Disclosure website at www.morganstanley.com/researchdisclosures. Please don't forget this website. If you have any questions, please reach out to your Morgan Stanley representative.

So with that, thank you, Greg. Thank you, Neil. Thanks for coming.

Gregory J. Hayes - *Raytheon Technologies Corporation - Chairman, President & CEO*

Our pleasure. It's so nice to be here in person. It's been since 2019 when we were last up here in beautiful Laguna Niguel. So thank you for having us.

And just a reminder, as well as Kristine's disclosures, reminder that whatever Neil and I, talk about there are forward-looking statements in there that are, of course, subject to risks and uncertainties. So read the 10-Q, the 10-K with all of that in there, and our lawyers will be happy and we won't go to jail, rule number one.

So just maybe a quick overview. Most of you guys know RTX, right? We're one of the largest aerospace and defense companies. Last year's sales were \$64.4 billion. For this year, we're seeing sales somewhere between \$67.75 billion to \$68.75 billion. That's the guidance -- the official guidance that it's out there. I would tell you all that based on some of the challenges we're seeing in supply chain and labor availability, probably going to be at the lower end of that range for revenue. But we'll see how the next few months progress.

On EPS, no changes. We're still at \$4.60 to \$4.80. That's the same guidance that we had in January. We maintained it throughout the year despite the Russian invasion of Ukraine and the impact of that on our top line and bottom line where we have been able to maintain it through some cost reduction.

And I think very importantly, yesterday, we updated our cash flow guidance, roughly \$4 billion of free cash flow this year. It was \$6 billion. And that \$2 billion is a gift of President Biden for the R&D tax credit. As you guys know, we spend about \$10 billion a year on R&D, which has historically been deductible in the year we incur it. We now have to defer and amortize it over 5 years. We were hoping that we would see that law changed. Not yet. If it changes back in December, if we get tax extenders, that money will come back next year. So we're actually making \$1.5 billion tax payment tomorrow and another \$500 million in December based upon the current law as written. So we'll see how that goes. Again, it is a short-term

loan to the government. And again, it will cost us over the next 5 years roughly \$6 billion in free cash flow if we don't have an opportunity to expense that.

Share buyback, about \$2.5 billion still. Most of that will probably be done by the end of the third quarter, and we'll see where we go from there. I think most importantly, though, the longer-term goal that we talked about 3 years ago was that we'd be able to return \$20 billion of cash to share owners in the first 4 years after the merger. And we are well on track to do that. Again, between the dividend and share buyback, over \$13 billion so far returned in the first 2-plus years after the merger.

And maybe just to end it, I know there's been a lot of discussion out there about supply chain and what's going on with labor availability. I would tell everybody that we are also impacted as every other industrial company in America. We are working actively to address it. It's tough, and it's not going to get better soon. But again, I think as you think about the longer term, those targets that we laid out about a year ago through 2025, we remain on track. We're going to see very solid growth, the top line, we're going to see solid growth on the bottom line. And we still expect very, very strong free cash flow in these coming years. So on track with the merger, on track with the integration and just working through, as is everybody else, the challenges of supply chain.

QUESTIONS AND ANSWERS

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

Great. Thanks, Greg, and thank you for the commentary. And digging deeper on your comments of supply chain. Can you provide more color on what you're seeing across your suppliers? And also what mitigating actions you're taking to address these concerns?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

Sure. As I said, RTX were not immune to the challenges of supply chain. And I categorize it in a couple of broad pieces. There are structural castings, which we've talked about as far back as January of this year, which is impacting Pratt's ability to deliver large commercial engines. We're working through that. We think we'll be mostly caught up with those deliveries by the end of the year, but some of them may drag into the first quarter.

But structural castings, first and foremost. We've all talked about electronics, chips. We remain hand to mouth just like everybody else. We are seeing some stabilization, I would tell you, in the supply chain there. We're working with our distributors, and it is just a day-to-day challenge. That's -- again, we don't see that rectifying itself until probably sometime in the middle of next year if we're lucky, and the people are bringing on more capacity.

We've talked a lot about rocket motors. My favorite rocket motor supplier has had some challenges with workforce. Right now, we don't think we're going to be back to contract on rocket motors until the first quarter of 2024. So a while.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

It's a long time.

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

It's a long time, and it's very frustrating. And I think it's -- so today -- I mean, every day, we have a production meeting with those folks to help them schedule the line, make sure they've got the material. We've got our employees over 330 of our critical suppliers working through these issues. One of the big challenges, of course, we've seen big increases in raw material costs.

And many of our small suppliers have seen huge inflationary impacts as a result of that. We're letting them use our long-term agreements to offset some of that cost. We're using our contract laborers to supplement their workforce. And we're just working through with each of these critical suppliers to help them get back on track, but it is -- there's a lot of pick and shovel work. And I think that will remain a challenge throughout the rest of this year.

Again, that's -- if you think about it, why you're going to be at the low end of the sales guidance, we're not going to get all the parts we need. It's as simple as that.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

And then labor, you mentioned that some of your suppliers are facing labor shortages. Can you talk about the labor issues you're facing versus what your supply chains are facing? What are the similarities or differences?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

Yes. So I mean everybody, again, I'm sure I just saw Kathy Warden leaving. She had -- I'm sure Northrop is having the same issues as we are in terms of labor availability and specifically on the supply chain. But let me just give you an idea of what we're doing.

So at Raytheon, we started the year with about 174,000 employees. We've hired over 23,000 people this year, about half of those engineers. We've lost about 15,000. So again, less than -- about 8% attrition, but we have been able to add quite a few people back today. I still have 13,000 job openings at Raytheon. That is the challenge that we all have, is where all those workers are going to come from.

And again, we're working with the supply chain. And they're struggling, I would say, more than we are in terms of trying to get labor in, and we're using again, contract labor. We're sending our folks out to their shops to help them to get through some of these bottlenecks. But it is -- again, if you think about root cause in the supply chain, some of the problems really goes back to labor and labor availability.

And with workforce participation, I think it's 62.2% or something. It's down a full point in the last 3 years. So a lot of workers that are not in the workforce today. And again, we hope as the economy cools down here that we're going to see some of these job openings, of which are about 11 million in the country slow down to give us a bigger pool of talent to draw from.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

And another key macro concern has been inflation. So can you talk about what you're doing to offset inflation this year? And what are the strategies you're also implementing to offset inflation in the future?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

Yes. So inflation, we saw the headline number yesterday, not getting better, 8.3%. We're clearly seeing inflation. And I would say, in the supply chain is mostly in raw materials and energy. Good news is on the commercial side of our business at Pratt and Collins, about 80% of our supply is on long-term agreements. So we're actually able to push back some of the inflationary pressures just because of these long-term agreements.

On the defense side of the business, about 1/3 of the work is cost-plus. That inflation gets passed on to the government customer. On some of the other longer-term contracts, we've actually been talking to DoD about reopening them because of the inflationary impact. And frankly, they understand that -- the DoD that many of the folks in the defense industrial base are going to be looking for some type of equitable adjustment to some of these contracts to deal with inflation.

I would tell you this year, about \$150 million to \$200 million of excess cost, and that number will be higher next year. Again, what are we going to do? Well, we're going to go out. We're going to work cost reduction through product redesign. We're going to look at productivity in the factories. We're going to look at second sourcing, moving more work to lower-cost locations.

And I would tell you the opportunity to reduce cost is still in front of us. And when we brought these 2 companies together a little over 2 years ago, we put a target of about \$1.5 billion of synergies. I think we're at \$1.3 billion roughly.

Neil G. Mitchill - Raytheon Technologies Corporation - Executive VP & CFO

About there by the end of the year, yes, \$1.3 billion.

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

\$1.3 billion. And there's more to come beyond that. We still have 187 OEM factories around the world, which is too many. And so we're going to pull out the playbook, and we're going to do cost reduction. We're going to take -- we're going to go move to lower cost sources. We're going to improve productivity in the factories. We've rolled out our operating system, our core operating system to give us some tailwind in the factories in terms of cost reduction. And it's just -- again, it's what we do every day.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

And shifting to commercial aerospace. First, it's great to see everybody in person. I mean a year or 2 years ago, it seemed impossible that we would have higher attendance at the Morgan Stanley Laguna Conference in 2022 from investors and corporates that we saw in 2019, but here we are. So in terms of your recovery outlook, Greg, it's probably great most of us flew to get here. I hope nobody drove from the East Coast. That's going to take you a long time to get home. Do you still expect 2024 as the first full recovered year for aerospace, Greg?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

We do. And I think, again -- so right now, we're sitting at about 75% of RPM of the 2019 level. That recovery is very uneven, as we know. We've seen a huge recovery here in U.S. domestically. It's been much, much slower transpacific in the wide-body routes. But we fully expect that we will see a recovery through 2023. So as we exit 2023, we'll be back to 2019 levels. And I think that, that should not be that difficult. I think the difficulty will be the airlines being prepared for that. And for those of you that have traveled commercially, you know long lines, short staff. It's a tough slog for the airlines today as they try and, again, find that scarce labor. There's pilot shortages and all the other challenges.

Having said that, by the end of next year, we think we should be back to that kind of 2019 levels. Interestingly, in China, which represents about 19% of the world RPMs, they have snapped back very quickly when the lockdowns end. And then again, they have another lockdown, and traffic drops down. The good news is the Chinese airlines, like many others, continue to bring their engines in for overhauls, continue to keep the planes in serviceable condition ready for the traffic when it comes back. So if you think about it, we're probably going to see 25% kind of growth in the aftermarket at Pratt, 20% to 25% growth in the aftermarket this year at Collins Aerospace. And again, strong growth next year.

And just to maybe go back on the inflation. The other thing that we're doing is we're looking at pricing. And we put out a catalog price increase early this year that will take effect next month. And that -- the price increase is healthy because it recognizes the fact that costs are going up. And so that is the one lever that we have that it's not popular with the airlines, but they have seen price increases, and they're going to see price increases in their supply chain as well.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

Great. And thank you for the aftermarket color. I mean that's a pretty solid growth. So specific to widebody, you also alluded to with the Asia Pacific traffic not kind of lagging the rest of the world. What are you seeing in widebody traffic? And are you seeing the return that you expected to see so far? And how is that factored in to your aftermarket outlook for Pratt and Collins?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

So fortunately, for Pratt, there's not much aftermarket associated with long haul. Again, they are primarily a narrowbody with the geared turbofan engines. But we still -- we've seen about a 20% increase over the last 12 months in long-haul traffic. It's a little slower than what we expected because China has not opened up as we had expected, but we fully believe that, that trend will continue as we get towards the end of the year and China reopens.

Again, a lot of this depends upon the party congress that's going to happen in October, and we're hoping that once president Xi is reelected that things will open up in terms of the Chinese economy. They're struggling there from a growth perspective, and they need to open up their economy. That will be a big boom to commercial air traffic in the Pacific region.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

Great. And switching to OE now. Can you remind us your growth outlook for Collins and OE and Pratt? And then within your Collins outlook, what are you embedding for the -- where are you in production rates for the 737 MAX and the 787? And for the GTF, how many do you think you'll deliver by year end?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

Okay. So for Pratt, we talked about OE, about 20% growth this year. So we'll deliver more than 700 geared turbofan engines this year. On the Collins side, I think it's going to be mid- to high teens kind of growth on the OE side. And I'll break down the components of that growth.

So at Boeing, we think that by the end of the year, they will be in about 31 737s a month. We believe there will be about 2 787s a month, again, way down from where they were, but a sustainable pattern through this year. At Airbus, I think they're at rate 48 today and rate 11, I think, on the A220, again, both good news for Pratt and for Collins for that matter.

If you think about growth in that business. So go out to 2025, right? And you think about how much runway is there. If you take a look at the projections for Airbus, we think that Airbus by 2025 will be at rate 65. And Guil might say rate 75%, but we think rate 65 is doable.

And the A220 will probably be up to about 14 a month. We think 737s will be back somewhere around 42 to 48 and 787 is back to probably 7 a month. Based upon those kind of growth rates, you would see over a 50% increase in OE revenue between Pratt and Collins between now and 2025. That's huge growth. And that's just again getting back to what I would say pre-COVID production levels at Boeing and Airbus.

So again, the growth is coming. The backlog is solid, but it's just going to take us a little while as the OEMs ramp production back up.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

Thanks for the color on aero. Maybe now on defense, I mean, we've seen the defense budgets around the world increase. We heard that from Kathy, not just domestic U.S., but also our international partners. When you look at your book-to-bill in the second quarter, you're at 1.35. So when we see these book-to-bill and these orders flow through, how quickly do you expect these awards to convert to revenue? And what do you think is a long-term growth number for the Raytheon defense business?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

So it's a great question, Kristine. And I think -- as we think about this, if you look at our backlog on the defense side, \$65 billion of backlog today. Many of that -- those contracts that will play out over the next 3 to 4 years.

We just signed a contract for Stinger MANPADS, a little over \$200 million. That contract starts this quarter and ends in 2028. So these things play out over years.

We just signed throughout 15 through 17 on the 135 engine. Again, that's the next 3 years' worth of production. So backlog plays out slowly. And we are seeing an incredible amount of demand for the product, whether it's replenishment of Stingers and Javelins, also NASAMS, these anti-aircraft systems that we're deploying into Ukraine, Patriot systems, LTAMDS, that's the next generation of Patriot. Demand remains very, very strong. And I think we're going to see growth in -- give me a number, Neil. Probably be...

Neil G. Mitchill - Raytheon Technologies Corporation - Executive VP & CFO

It's going to be -- yes, mid- to high single digits. I think the thing we're going to have to watch as everyone is, is how can the supply chain get ready for that level of volume. There's no doubt that the demand is there in the system. And as Greg said, it will play out over a number of years.

Calling a particular year or quarter right now is a little challenging. But certainly, having this kind of visibility is going to help us get ready and get our supply chain ready to deliver on that demand. But it should be very robust growth. And I think that's why we feel good about those 2025 numbers that we put out there a little over a year ago now.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

So Neil, just to confirm, you said mid- to high single digits through 2025 for the defense business?

Neil G. Mitchill - Raytheon Technologies Corporation - Executive VP & CFO

That's right. Yes.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

And maybe switching to a more specific topic on the F-35 -- with the F135 engine. How are you guys thinking about the upgraded F135 versus the clean sheet design? And do you think it'll still be full source?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

So there's a lot of variables at play as it relates to the F135 engine. There is a program -- a development program underway for something called the adaptive engine or AETP. I think GE has just completed its testing -- flight testing. We're in the process of doing our flight testing on AETP. And AETP engine is a very different design than the current 135. Instead of having 2 streams of air that go through it, you're going to have a third stream, which at supercruise allows you to cruise a lot more efficiently, get maybe 20% better fuel burn. The problem with that engine is it will cost \$6 billion or \$7 billion to develop, and it probably won't be ready until 2030. Then getting the hours on it to actually be comfortable putting a brand-new design in a single-engine aircraft is going to take another number of years. And the last challenge that we have is, while the Air Force is very supportive of the adaptive engine for the A models, the engine -- the adaptive won't fit on the B and C models, and the international partners don't want it.

So we're going to have a competitive offering against GE with an adaptive engine. We think the more likely outcome is the adaptive engine will be used for the sixth-gen fighter as opposed to replacement for the F-35 engine. We have proposed to the DoD something called the EEP, which is the enhanced engine program. It is a program of about \$2.5 billion. It's about a 4- to 5-year development. And essentially, it's taking some of the new technology off of the adaptive, and incorporating that into the existing 135 to get you about 15% better fuel burn at a much lower cost and a much higher reliability.

And so we are very focused working with Frank Kendall with the Air Force and Bill Platt at ANS to make the case for funding the EEP. There's money in the budget for 2023 for starting development of that. And we'll see how it plays out.

At the end of the day, putting the adaptive engine into the F-35 means you're probably going to have 100 less F-35 aircraft out there in order to fund the development. So we think that the choice is pretty clear, but we'll see what happens. We'll support either option. And just -- it will take some time. It will work itself out here in '23, I think.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

And moving to capital allocation. We know that you've committed to returning about \$20 billion to shareholders in the next 4 years after the merger, right? And so how do we think about the mix between dividends and buybacks for that \$20 billion? And then how should we think about potential M&A? Is that an additional dollar amount? Or is that within that \$20 billion as well?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

No. I would -- whatever M&A activity we do, I don't think it will be big. It would be outside of that \$20 billion. So if you think about that \$20 billion, we'd characterize that as probably \$12 billion of dividends and \$8 billion of share buyback. So we started share buyback again last year. As I said earlier in my comments, probably do almost \$2.5 billion through the end of September this year. So well on track to get towards that \$8 billion of share buyback.

The dividend, it's pretty healthy. We raised it 7% back in this early summer. And we're going to continue to grow the dividend in line with earnings. And we think that payout ratio in that kind of 45% range is about right.

Interestingly, this inflation, they call it the Inflation Reduction Act, I call the Inflation enhancement act and actually has that 1% surtax for share buyback. Nobody cares. It's 1%, and it's not going to change our plans whatsoever. And keep in mind, that's a net of whatever shares that we issue for compensation plan. So it's just not going to be a big deal for us. And we have a number for that?

Neil G. Mitchell - Raytheon Technologies Corporation - Executive VP & CFO

It's 1% of \$2.5 billion.

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

\$25 million equity.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

And maybe following up on that \$20 billion number. You've talked about mid- to high single digit growth in the defense business with strong visibility to 2025. So commercial aerospace, we are 75% of the way through. It seems like there's visibility for return to 2024 for fully recovered aerospace. With -- you talked about 50% upside in OE revenue as well. I mean when you look at the next few years, you've got visibility, you've got growth. How much upside could there be in that \$20 billion capital return number?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

Kristine, it's a great question. I'm not going to make news today by raising that \$20 billion, but I think we're going to be opportunistic in terms of returning capital. As I said, as it relates to M&A, I just don't see a path, especially in today's regulatory environment, to do anything significant on the M&A front. I think that's -- that ship has sailed as long as this administration is in power in Washington. And frankly, we don't need to do M&A. And so I think there will be -- if you think about 2025 and the \$10 billion of free cash flow that we had forecast, there will be an opportunity, obviously, to do more share buyback.

Again, the dividend -- I can't see the dividend ever going above like 50%. But clearly, share buyback, especially if the share prices remain depressed, is clearly under intrinsic value today, the whole market probably is given the sell-off yesterday. So we'll be optimistic, and we'll see what that number looks like at the end of next year. But \$20 billion is the baseline, I would say, for capital, and we'll go from there.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

And back to your 2025 targets. You talked about leveraging your CORE operating system to drive structural cost savings. And can you give us more detail about the different buckets that get you there between supply chain, operational excellence, the footprint and digital transformation you mentioned earlier? And how are you progressing on each?

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

I'll turn that to my CFO.

Neil G. Mitchill - Raytheon Technologies Corporation - Executive VP & CFO

Yes. No, I would say the -- we're doing a great job on cost reduction. Obviously, we're facing a few more headwinds today than we anticipated 1.5 years ago in the form of inflation. But we've got excellent operating discipline in place at the company that was started years and years ago. It was sustained through the integration activities, bringing rates Raytheon and UTC together. And we've expanded from not just the merger integration cost reduction activities, but also to procurement and deploying capital in an intelligent way to drive automation and digital designs into our engineering planning upfront.

So we host monthly cost reduction summits at the company. Chris Calio and I participate in those on a quarterly basis, at least. There's incredible rigor that we've got in that process. Each business unit comes in, and each corporate function comes in, explains the project pipeline that they have, how they're making progress in terms of growing that project pipeline and then executing against the savings that we're expecting to see there.

So while I expect that \$5-plus billion that we put out there to grow in absolute terms as well, we'll have a few more headwinds. We're still targeting at least \$2 billion of net drop through from the 2020 period forward. So I think we've got the right ingredients there. It gets a little bit harder, but we're going to continue to drive productivity and prioritize the allocation of our capital investments to make sure that we're putting our money in the right places.

A lot of projects that we may have looked past or put to the bottom of the pile a couple of years ago are a lot more attractive today when you look at where inflation has taken the cost of manufacturing, energy prices, shipping and et cetera. So we're revisiting some of our old plans, and those projects are making their way to the top of the pile now. We'll go make sure we make the right investments.

I'm very comfortable with the level of capital that we have in the multiyear outlook that we talked about a couple of years ago. So we've got about \$2.5 billion, \$3 billion of CapEx, \$3 billion of R&D. I think our long-term investments are about the right level for what we see coming down the pipe in terms of technology demand as well as the need to go offset some of these headwinds that we're seeing.

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

I would just add just a couple of points. There is no cost at RTX that is fixed, right? We take a look at -- kudos to Chris Calio and Neil for these cost summits because they're digging in at a level of detail that you wouldn't think you would do in a \$70 billion business. But there is an opportunity for cost reduction in the factories, in the supply chain and in the back office.

And already you know, Pratt & Whitney is in the process and again, shoutout to Shane Eddy, the President of Pratt. They're looking to take out \$500 million of cost at Pratt over the next 3 years. And again, this is over and above what they had been looking at prior.

So cost takeout is an everyday focus throughout the organization. And it's a muscle, you've got to exercise every day because you really -- there are opportunities out there.

Kristine Tan Liwag - Morgan Stanley, Research Division - Equity Analyst

Well, great. Looking at the time, that's the time that we have. Thank you, Greg, and thank you, Neil, for joining us for today's session. And this concludes the Raytheon session.

Neil G. Mitchell - Raytheon Technologies Corporation - Executive VP & CFO

Thank you.

Gregory J. Hayes - Raytheon Technologies Corporation - Chairman, President & CEO

Thank you, Kristine, and thank you, everyone.

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