BASF Analyst Conference Call FY 2016

Transcript – Q&A by Topic
February 24, 2017

Contents

1 BASF Group

1.1 Outlook

Paul Walsh (Morgan Stanley): My question is on China. Kurt, I don't know if my maths is correct. I think you said volumes grew in China by about 12 percent last year. If my memory serves me correctly, it is about a €5.6 billion business for you. When I run the maths, it feels like China represents about half of the incremental volume growth that you saw last year, both over the year as a whole and obviously the acceleration in the second half. I wanted to know: If that maths resonates with you, where do you see the upside or downside risks to repeating that into 2017?

Kurt Bock: China: Yes, we had a very positive growth development. We have a strong and big exposure through the automotive industry and the automotive industry developed very nicely last year. We are a little bit more cautious with regard to automotive growth in China for 2017, but it will continue to grow, which is important. We most likely will also be able to increase our share, which is even more important. I am just trying to do the maths in my head. Yes, it plays an important role. 12 percent on roughly 10 percent of sales, does it really translate into half of our volume growth? It is a lower share than what you had calculated here. But it plays an important role. And certainly going forward, Asia is supposed to continue to be a growth engine for BASF.

Andreas Heine (MainFirst Bank AG): I would also like to ask on the outlook. If I take your sensitivity for the U.S. dollar and your outlook for the U.S. dollar and the same for the oil price and the sensitivity, if I add Chemetall consolidation and take the normalization of the gas production at Yuzhno Russkoye into consideration, I would end up already with these factors at almost €800 million, which is already more than a double-digit increase. And that does not take into consideration that the Other line most likely will normalize and that the impact on the interruptions you had in Q4 from the fire in Ludwigshafen had also most likely an impact mainly in 2016. Could you elaborate a little bit why these factors are not enough to make you optimistic enough that the earnings increase double-digit?

Kurt Bock: I think what you have done here is fair and not unrealistic. You have to put probabilities behind some of those events. What we are doing here is essentially that we are saying: We have very limited visibility with regard to the second half of 2017. I think actually nobody really knows what is going to happen. I mentioned the geopolitical risk and external factors. All of this might happen. For those reasons we just thought it prudent to guide the way we have done. Once again: This means up to 10 percent. If you take the 10 percent, you are not that far from the €800 million you had mentioned. Then there is a certain level of uncertainty.

Andreas Heine (MainFirst Bank AG): Basically, with the slight increase you look more to the really upper, upper end of this range, so the 10 percent. Is that fair?

Kurt Bock: That is a correct statement, yes.

Andrew Benson (Citi Investment Research): You have got €150 million of costs which occurred in 2016 with Gazprom which won't recur. We talked about a couple of hundred million start-up costs last year. Presumably, that is going to be down as well with your cost reductions and who knows what, but the Long-Term Incentive Plans.

If you assumed that the market conditions will continue – I know there are geopolitical risks, but there are always risks in everything. But if you think that the current trends will continue, what sort of upside could you be talking about into the second half? Or are you just giving that forecast simply to be cautious in the event that things get more difficult?

Kurt Bock: If I would just go by the Q1 and what we see right now in the momentum, also in terms of volume, there might be a reason to be a little bit more optimistic for the entire year. But, again, I am coming back to what I said earlier on: We don't know what is going to happen in the second half of 2017. For that reason, we simply think that this is a prudent forecast from today's point of view.

Yes, there is always a possibility that all things move in a right direction and everything develops nicely, but experience also tells us: You will always get hit from one side or the other and sometimes in an unexpected way. This kind of uncertainty we try to incorporate in our forecast.

Jeremy Redenius (Sanford C. Bernstein & Co.): You made a comment about Europe's flowing in your outlook for 2017. I am curious to hear more detail behind it. Are there particular geographies within Europe that concern you or any particular end markets that you see slowing down?

Kurt Bock: Europe slowing down. To be a little bit more precise: We expect something like 1.3 percent growth in Europe. That compares pretty much with 1.5 percent consensus. So you might say, we are a little bit more conservative. This reflects a certain uneasiness about what we see in some countries: retail spending slowing down in the U.K., there are certainly risks in southern parts of Europe. Maybe we are here on the conservative side, maybe not. So far, the start of this year and the economic indicators we see going into 2017 would underline a slightly stronger development, but again early development in 2017.

Andrew Stott (UBS): This question is on guidance – the circular reference that may be in this guidance: If we assume that you are too conservative on your chemical guidance, do you come back to the market and have to recalibrate on your downstream guidance? I am just going back to your point, Hans, just now, e.g. on the raw materials price increase. If you can just educate us on the extent to which your guidance downstream is based upon a significant deflation in cost through the next nine to ten months.

Kurt Bock: I explained the assumptions which are the basis for our guidance. If we see over the course of the next couple of months that things move more positively, I think this would be a high-class problem and we would certainly be able to adjust.

The guidance of the different segments is not completely independent from each other insofar as raw material costs play an important role. But, again, I propose that we revisit that question when we have a little bit more visibility with regard to the next couple of months.

1.2 Other topics

Jeremy Redenius (Sanford C. Bernstein & Co.): Looking at cash flow in the fourth quarter, specifically before changes in working capital, it looked relatively weak in Q4, down quite a bit year over year. I am wondering if there is anything in particular that was holding back the cash flow before changes in working capital compared to the EBITDA development in the quarter.

Hans-Ulrich Engel: I am not so sure that I am seeing the same developments that you are seeing. Our Q4 operating cash flow doubled compared to Q4 of the prior year. If I look at free cash flow, we were negative in Q4 of last year and we were positive to the tune of €650 million in the fourth quarter of this year. So, overall, I thought, from a cash flow perspective, that looked pretty good.

Jeremy Redenius (Sanford C. Bernstein & Co.): Just to clarify: I was looking at it before changes in working capital specifically. So it looked like it went from €680 million free cash flow before working capital last year to about €150 million this year. There was a big working capital outflow last year, a cash release that boosted last year's figures.

Hans-Ulrich Engel: Let me take a closer look there and I'll get back to you.

[As mentioned in the explanations on the cash flow on page 58 of the BASF Report 2016, the line "miscellaneous items" includes the transfer of disposal gains from cash provided by operating activities to cash used in investing activities. In Q4 2016, there were several divestitures and asset sales, in particular the sale of the industrial coatings business, which were deducted from the operating cash flow. Compared to Q4 2015 the impact was almost €0.5 billion, thus explaining most of the swing in that line item. What should also be noted is the fact that the total of net income and depreciation for Q4 2016 was almost on the same level as in Q4 2015. However, in both quarters there were substantial non-cash items, in particular a swing in other provisions, e.g. for LTI and income taxes. An interpretation of operating cash flow excluding working capital is therefore misleading.]

Laurence Alexander (Jefferies & Company Inc.): How are you thinking about D&A and also the amortization that you will be excluding from adjusted EPS in 2017?

Kurt Bock: Laurence, with regard to adjusted EPS: We don't foresee any changes with regard to depreciation, amortization compared to last year.

Martin Rödiger (Kepler Cheuvreux): On the regional development: I saw that EBIT in Germany as well as in North America decreased substantially in Q4. Is the reason the Long-Term Incentive Program? Or with respect to Germany: Is a specific impact from the accident in Ludwigshafen the reason for this strong decrease?

Hans-Ulrich Engel: I'll start with Germany: You exactly hit the reasons. One is the Long-Term Incentive Program; that sits almost exclusively at that point in time, at year end, on the books in Germany. And the second is obviously also the impact from the incident that we had in the North Harbor. That impacted the results of Q4. So these are the two explanations there.

You also asked with respect to North America: The decline in results there is driven by the declining cracker margins that we have experienced in 2016 and then also in particular in the fourth quarter of 2016 where actually the cracker margins, if you compare it with Europe and Asia, were the lowest in the U.S. compared to the other two regions, while they were still quite strong in Q4 of the year 2015.

Tony Jones (Redburn): It looks like your capex guidance for the next four years is about half a billion lower than guidance in 2016. And it also looks like the capital allocation to Chemicals is reducing whereas you are allocating more into the specialty divisions. Can you talk a little bit about whether this is a sustained trend and how you see the potential returns on organic growth versus acquisitions?

Kurt Bock: Capital allocation: Yes, you are correct. We have reduced the five-year plan by €0.5 billion to €19.0 billion and there is a slight shift from Chemicals to the downstream businesses. This reflects current knowledge obviously. These plans are updated every year. From today's point of view, this looks sensible and sufficient to fuel organic growth for BASF. At the same time, it also brings capital spending closer to depreciation levels, which is one of our targets. That would also then free up funds for instance for M&A, which always has been one tool for us. We have done a little bit in 2016 with Chemetall. It needs to be seen whether we find additional targets which are worthwhile to spend money for. So this is all speculation at this point in time, but we are certainly interested in adding businesses which fit strategically and create value for our shareholders.

Andrew Stott (UBS): This question is on China. I am just looking at your reported accounts, the JV that you consolidate: You show net income going from €64 million last year to €332 million on a fairly minimal sales increase. I am sure there is some one-off. I am trying to get an idea of the context for China in general. How clean are those numbers?

Hans-Ulrich Engel: On your question on BYC: You are absolutely right. Sales increased by a small amount there, earnings increased significantly, margins expanded. We have seen a nice margin boost there, in particular in the fourth quarter. Please keep in mind that depreciation has come down quite significantly because some of the plants that we still depreciated in 2015 were ten years old in 2016. As a result of that, depreciation drops quite a bit. Thus, I would say, the numbers are clean.

Andrew Benson (Citi Investment Research): Can you just let me know the total costs in the fourth quarter and the probable total costs in the first quarter of the accident you have had and how you have allocated that? I presume a lot of that will be offset against insurance. Have you accounted for that within the figures? Or are you going to take the insurance gain at some point in the future?

Kurt Bock: The accident in October 2016: The effect in terms of loss of contribution margin is something like a low double-digit number per month. This continues going into 2017, since we have not been able to re-establish the entire supply chain operations. There are still some bottlenecks which essentially affect Petrochemicals and some of the Performance Products businesses. We have a deductible in our insurance. That deductible already was included in the 2016 numbers. Apart from that there is an ongoing discussion with the insurance company about how to account for this and the final invoice will be done later this year.

2 Segments

2.1 Chemicals

James Knight (Exane BNP): There are a couple of questions around the Chemicals segment outlook for 2017: You just talked about the uncertainty and volatility. Also we can see, obviously, the year-end did very strongly and probably 2017 started very strongly. With the guidance of flat EBIT, clearly you are pointing to some normalization through the year, probably in the second half. How concentrated is that risk? Or is it more of a general concern, perhaps what is happening in China, perhaps about U.S. capacity coming on stream? The second part, looking more specifically: In the Annual Report in the outlook statement you talk about strong capacity pressures in products including isocyanates. How much of a potential normalization of MDI and TDI in the second half from superheated levels at the moment do you fear was baked into that outlook?

Kurt Bock: Chemicals is the most critical segment in terms of providing a guidance here. What we said is: We want to match last year's level. Quite clearly, that is almost impossible mathematically because it really means plus/minus zero percent. We all know that in Chemicals, given the volatility and supply/demand dynamics, there is a certain unpredictability.

So, our goal is certainly to have earnings higher and above last year's level. However, as you said, we have a certain base effect from a very, very strong Q4. Q4 saw good results in Petrochemicals, but also in what we call Monomers. Monomers is in this case especially isocyanates.

Your question is: How concentrated is this really? Clearly, in isocyanates we have enjoyed – I think this is the right word – very good margins in Q4. This continues going into Q1. But frankly, it is very, very hard to predict whether this will continue in the second half of 2017.

Against that background we chose to have this from your point of view most likely a little bit too cautious statement: earnings at last year's level.

Nobody actually knows what is going to happen in the second half of this year. There is new capacity coming on stream. So far demand is healthy, continues to be healthy. Petrochemicals and Monomers run very nicely.

In Intermediates, the third division of that segment, we have a couple of issues. One is: The margins in BDO are weak. Maybe they are bottoming out, but they are weak and not really satisfying. Secondly, we have a couple of turnarounds coming up in 2017, especially in that segment, which might also play a role. This is by and large our explanation.

James Knight (Exane BNP): Do you have any view on the likely phasing of the new crackers that are on stream in the U.S.? Are you assuming there is any delay into 2018?

Kurt Bock: That is very hard to say because in most cases these announcements are made on very short notice and we have no special insight or special view on that. As you know, we run one cracker in Port Arthur and that is essentially our exposure to the cracker business. That cracker, again, is predominantly for captive use.

Paul Walsh (Morgan Stanley): Just to come back to the polyurethanes chain – I know it's only one of your many businesses: But would you concede the outage situation last year helped boost profits? Assuming everything runs, what are your views on MDI and TDI? Are those markets in balance? Are they oversupplied? Are they undersupplied? We are getting different messages depending on whom we speak to on that.

Kurt Bock: Polyurethanes: Yes, there have been outages last year, including at BASF in TDI. We have been able to use our global production network to deliver to our customers. We continue to run our operations in Schwarzheide in the eastern part of Germany, thus mitigating the effects. It is very difficult to predict what is going to happen in that industry because there is a certain likelihood that you will have trips and capacity is not available. We have seen this again and again across all competitors. There are better years and worse years with regard to this type of asset, what we call asset availability. Our goal is certainly to improve in that respect.

We also know that new capacity will come on stream over the course of this year. We don't know the exact timing. I have no insight on that one. Overall, the markets are growing nicely. Growth is essentially above GDP, one to two percentage points, which is not too bad. But, clearly, this is a supply/demand-driven business; that is one reason why we have been so cautious with regard to guiding for chemical earnings in 2017.

Paul Walsh (Morgan Stanley): Are TDI Ludwigshafen and MDI Chongqing both now back in line with expectations or are you still seeing some reduced outputs of those facilities?

Kurt Bock: MDI Chongqing is developing as expected. We cannot run at full capacity because we have constraints on the raw material side. One of our partners has a bottleneck and we are working on that one. But it was a very positive, good growth story in 2016.

Our TDI plant in Ludwigshafen is still idle as we speak. We have to do some repair work. We want to bring it back within the next couple of weeks. For the time being, we are bridging with volumes from our plant in Schwarzheide.

Jamie Wang (Nomura): My question focuses on MDI capacity in China. I was just wondering why you still want to expand the capacity in Shanghai, double your capacity there this year. Would you consider expanding your capacity in Chongqing in the next few years?

Kurt Bock: On MDI we have a joint venture in Shanghai. Yes, there was a new plant announced a couple of years ago and this is under construction. There is new capacity coming on stream. In Chongqing, we do not plan additional capacity. However, we still have capacity available to be filled.

What we have seen in 2016 is – not a complete surprise – that sometimes also asset availability is not what it is supposed to be. So there had been some trips and some capacity – not on our side, but in the market – was not available. That has certainly also led to a certain tightness in Asian isocyanates markets.

2.2 Performance Products

Martin Rödiger (Kepler Cheuvreux): One question on Care Chemicals: Can you provide us with an update about the competitive situation in superabsorbents? Do you see some light at the end of the tunnel? How do you make progress with your new technology in superabsorbents?

Kurt Bock: With regard to Care Chemicals and, more specifically, superabsorbents: This has been a pretty nasty development over the last two years. Margins have come down. There is obviously oversupply. Customers have become extremely price-sensitive, given the supply/demand situation.

There is still good underlying growth in terms of 3 to 4 percent. However, there is simply too much capacity available. We clearly see this also in our numbers. You can also see it in the volume development of the Performance Products segment in Q4, a flat development, which was essentially only due to a decline in superabsorbents. So it had quite some impact.

Our path forward – you mentioned this: It is a different technology. We call it SAVIVA; it's drop polymerization. These pellets have a higher capacity to absorb fluids, also much faster. Customers want it. We are building a plant in Antwerp. The plant is a swing plant, so we can do both, the old and the new quality. The new quality is, as I said, an interesting development, but at these prices now, also based on relatively low propylene prices … Again, the price sensitivity of customers is extremely high. They see the technology advantages also in terms of branding and how you position this, but it will take some time to phase these new products into the market.

Peter Clark (SG Corporate and Investment Banking): Looking at Performance Products: Obviously, in the fourth quarter there was no margin improvement year-on-year. In the first nine months you are running at 400 basis points. The main mechanics you see working in there in 2017 – I noticed you see an uplift in the fixed costs with the new plants starting up and you had a big year in 2015. So that's an element. You have got raw materials, but also a lot of cost-cutting still coming through this year from the program you have done. You have vitamin pricing.

Hans-Ulrich Engel: I'll address your Performance Products question: Keep in mind the seasonality that we have in that business. If you look at the years 2013, 2014, 2015 and the fourth quarter that we have there, you always see the same pattern. Q4 in Performance Products is the weakest quarter of the year. That is one thing. The other thing that we have is: Performance Products and Chemicals are the two segments that are affected by the incident in the North Harbor. That is clearly to be seen in the results that we generated in Q4 with Performance Products.

Peter Clark (SG Corporate and Investment Banking): It was more about the guidance for Performance Products, not Q4. I hear what you are saying, but you are obviously indicating no significant margin advance from Performance Products despite the cost-cutting. Obviously, one of the drags is more fixed cost coming in with the start-ups. What were the main mechanics for that guidance of very little improvement on the margin, if any, in 2017 in Performance Products?

Hans-Ulrich Engel: Keep in mind that we are in a situation where raw material prices have increased significantly. Compared to Q1 of last year, if I look at the entire raw material portfolio, we have a cost increase there of 41 percent.

If you do a margin calculation on a relative basis, that automatically will lead you, on a percentage basis, to a decline. But on an absolute basis – that's what we really measure – delta margins in euros and in U.S. dollars or whatever the currency is, we fully intend to grow that business profitably, also in 2017.

Andrew Benson (Citi Investment Research): On the Performance Products raw materials cost increase: You are talking about a slight increase in profits. You are talking about the year having started very well. You are also talking about a 41 percent increase in raw material costs. I know that those aren't necessarily intimately connected, but can we imply from that that you are having significant success in fairly aggressively and rapidly passing through those cost increases as we speak in the first quarter?

Hans-Ulrich Engel: On your raw materials question: Keep in mind that when we compare now we find ourselves in a situation where in January of last year we saw the low in oil price of 26 dollars per barrel. We had a naphtha price last year in January of 245, 248. The oil price has doubled, the naphtha price has doubled accordingly. We see this going through all value chains. Overall, when we look at January, February, we find ourselves with respect to raw material prices in a range of roughly 40 percent increase over the prior year quarter, which apparently was very weak with respect to raw material prices.

We have to pass on raw material price increases. Based on everything that I can see right now, we are quite successful in doing this. The strong demand that we experienced in Q4 where we first experienced steeper raw material price increases continues also in Q1. So I hope that we can actually pass on all the increase that we are seeing.

2.3 Functional Materials & Solutions

Tony Jones (Redburn): Just a short question on Chemetall and guidance: Can you confirm if that is all going to be absorbed into Functional Materials & Solutions? And if that's right, then my simple maths suggests that your guidance for 2017 implies your base business doesn't grow at all and potentially could contract. Why is that?

Kurt Bock: With regard to Chemetall, I am not aware that Functional Materials & Solutions would only grow due to consolidation effects. Our goal is to grow the underlying business as well. So that should work out quite nicely. That's the way we see it. Certainly, these businesses want to grow. That has been our budget discussion late last year.

Peter Clark (SG Corporate and Investment Banking): One question on Functional Materials & Solutions: You are indicating a margin down, but I presume the drag there is probably the effect of mix and automotive.

Hans-Ulrich Engel: Functional Materials & Solutions: We guide there for further profitable growth. Are there some uncertainties? Yes, there are. Automotive grew strongly last year. For this year we are a bit more cautious with respect to growth rates in automotive. Reasons are the high volumes already reached in North America, at a rate of 17.5 million units. But we also have seen significant stimulus, in particular in China, coming out of the sales tax. That was reduced from 10 percent to 5 percent in 2016. Now they continue with partial stimulus. It's now 7.5 percent on engines of up to 1.6 litres. And it remains to be seen what kind of an impact that has.

Overall, we think that we see slower growth in automotive, in the transportation industry than what we have experienced in the prior year. We also see that there is a slowdown in construction business in the second half of 2016, in particular in the Middle East, which is a strong part of our portfolio in construction chemicals.

Taking all of these uncertainties, we still see further profitable growth in our Functional Materials & Solutions segment.

Kurt Bock: Let me just add one comment with regard to Functional Materials & Solutions: Please keep in mind that we also did some divestitures last year. So you have to take out the earnings from polyolefin catalysts and from industrial coatings when you do your maths for 2017 compared to 2016.

2.4 Agricultural Solutions

No specific questions on the Agricultural Solutions segment

2.5 Oil & Gas

Andrew Benson (Citi Investment Research): On Oil & Gas, can you just remind us when the Achimgaz production starts to have an impact?

Hans-Ulrich Engel: Achimgaz I A is fully in line with what we said, currently producing out of 80 plus wells, the field is being developed. The target to be reached in the first half of 2018 will be 110 wells. So it's perfectly in line with what we had planned there. I assume when you ask about Achimov you may also include in your question IV A and V A. On that, current plans are: start-up in the first half of 2020. That is a change to what we said originally, because originally we expected this to start up towards the end of 2018. So there is a slight shift there, taking market developments into consideration.

Laurence Alexander (Jefferies & Company Inc.): Can you give an update on how you are thinking about Oil & Gas growth, on growing the reserves over the next several years? There have been some headlines about discussions with Iran, but also just the broader landscape.

Hans-Ulrich Engel: On the reserves: We are currently at an R/P ratio of ten years. So that's exactly where we want to be. We want to be in this range of eight to ten years with respect to 1P reserves. We have a nice position there, as already alluded to, with respect to Achimov IV A and V A, which is currently in the development stage, which means that there should be nice additions coming there.

Looking at overall oil and gas prices in 2015 and 2016, we have reduced exploration work to a certain extent, so not too much to be added there in the year 2017. But expect us to keep this range of eight to ten years which we feel very comfortable with.

Your Iran question: In April of last year, Wintershall signed an MoU. We are in very, very, very early stages of looking at data. It's mere desktop analysis that we are doing at this point in time, and it remains to be seen what will happen there.

Laurent Favre (Evercore): On Oil & Gas: I am trying to understand the operating leverage of that business, on E&P, as we see increasing prices, especially on the Brent side where I think you reduced exploration cost. You just said that you were quite happy with exploration cost, where they were in 2016. Does it mean that if we were to see oil and gas prices or Brent above 55, your assumption for 2017, that you would be quite happy to just take the incremental profits or would you actually be tempted to just reinvest into exploration to try and maintain your asset life to ten years?

Hans-Ulrich Engel: It remains to be seen. When you look at our results that we generated with the Oil & Gas business in 2016, when you keep in mind that even in that year we were able to generate a positive free cash flow, you know that we pulled all levers that we could. We moved cost down wherever we could. Depending on where the oil price is, I think I am willing to give my guys in the Oil & Gas business a little bit more leeway going forward.

Patrick Lambert (Raymond James Euro Equities): I have a very quick question on Oil & Gas, again. I am trying to gauge 2017. If I look at the 2015 appendix in the Annual Report, some of the numbers of 2015 have changed versus what was reported last year, especially in Russia. I was just wondering if it is the Yuzhno Russkoye adjustment that you adjusted in the Annual Report. Or is something else in there? What do we need to focus on in 2016? I think it was basically a one-off for the past ten years?

Hans-Ulrich Engel: You are right; we have some changes there in the numbers for 2015 due to changes in the standards. But I am thinking about the audience for this call and how long it would take to walk you through that in detail.

[See explanations on page 223 of the BASF Report 2016.]