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BASF Investor Day 2015

Transcript Keynote - Q&A

Ludwigshafen

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Andreas Heine (Barclays Capital): Two questions, if I may, one is on shareholder return and the dividend policy. You outlined that the capex will go down. So far, it was said that acquisitions play a role, but only the mid-size ones, not the larger ones. The balance sheet is very strong and with lower capex and your profit targets you most likely will also increase the free cash flow quite a bit. What does it mean for the pay-out ratio in the future? Will dividend rise faster than earnings? Are share buybacks on the agenda in the future or not?
You stressed several times that M&A is important for BASF and that the growth targets are a combination of organic and acquisition growth, but that acquisitions become more difficult to get to. Has anything changed in the last year in the way you look at acquisitions going forward? Do you like to spend more than you have spent in the last four years or in different areas?

Kurt Bock: Thank you, Andreas, for your question. Share buybacks: We have the tool available. It's not a priority at this point in time. We have to find a balance between our rating which is the debt expectation, and the equity expectation. So far, I think, that balance was okay. We will continue to grow our dividend. I think it's a little bit too early to speculate about whether that dividend could go up faster or at a speed which we have seen in the past. We also have to keep in mind the volatile environment we are facing right now.
M&A: The environment is an interesting one, because you see quite a few transactions going on at multiples which are quite high from our point of view. So I think we will continue to stay very disciplined here. We are constantly, as you can imagine, scanning the market for opportunities. We will always have small and medium things going on, but that's all I can say at this point in time.

Markus Mayer (Baader Bank): Two questions as well. Firstly, again coming back to M&A: Previously, before this Investor Day, you said you'll play an active part in the sector consolidation. It looks like this has become less a focus. Might this become a focus again when the overcapacities are fully hit or coming capacities hit the market? Or is this completely out of your cards for the next years?
Secondly, you already elaborated on Asia and Latin America. Can you update us on the current business environment there and what you see and what you expect for the next months?

Kurt Bock: Markus, thanks for your question. M&A is not out of the cards so-to-say. It will remain a very important cornerstone of our strategy going forward. We always have been very active, but we also – I can only ask for your understanding – have a certain way of doing it: For instance, we don't talk about it, frankly. You only talk about it when you really think that there is something tangible to communicate. So the scanning goes on, but it's absolutely premature at this point in time to speculate about anything concrete. Hans, you will talk about Asia and South America.
Hans-Ulrich Engel: Let me start with South America to confirm it: Very difficult business environment. We haven't seen a change there – since you asked about current trading environment – in Q3; compared to the situation that we experienced in Q2, certainly not a change to the better.
Asia: Also in Q3, I would describe it as more headwind than tailwind. We all followed the recent developments in China where growth based on what we see is certainly not at 7 percent GDP growth. India, on the other hand, has a very positive GDP growth, seems to be at a level of 7 percent. You know that we have invested in India quite a bit. We have started up our activities in Dahej, all still relatively early stages. We certainly hope that this will also contribute on the way going forward. But also, and that in summary with respect to Asia in Q3, certainly not an easy environment to operate in.

Laurent Favre (Bank of America Merrill Lynch): The question is actually helping me to reconnect slide 10 and slide 18. Slide 10 is one where you showed a real chemical production growth of 3.9 percent. Slide 18 is the one where you showed that, excluding Oil & Gas, BASF has had volume growth of 1.5. So I am just wondering if you can try to bridge the 1.5 to the 3.9. Is it the case that the geographical split of BASF is just not favorable, i.e. you have had better growth in Asia Pacific and you are not there or, let's say, that your percentage of sales there is too small? Is it that you have been focusing on value chains that have just had lower growth? Is it the case that you have not been chasing volume growth that has been at low profitability?
In other words: What is going to change from here so that you can reconnect to the growth of chemical production?

Hans-Ulrich Engel: Let me try to answer that question. Yes, it's certainly right when you look at the figures. Part of the explanation you gave already. It is our geographical footprint which we are actively addressing with capex that's allocated to emerging markets and there in particular to China. China, overall in the BASF portfolio, stands for roughly 6 billion in sales which is, if you compare it to the size of the Chinese chemical market, still relatively slow or small, even though we have nicely increased our sales over time in China.
Then you have to keep in mind that in certain areas we clearly made decisions that we don't want to play in, such as e.g. the polyolefins. So if I look at it from the perspective of our strategically relevant market, we look certainly much better than when you compare it to the overall chemical market. I think these are the key explanations. Again, our geographical portfolio we are addressing; that is one of the key reasons why we allocated much more to capex – because that allows us a more focused approach with respect to the emerging markets where it is extremely difficult to do acquisitions because they tend to come with what I occasionally call excess baggage that you don't want to have in your portfolio.

Tim Jones (Deutsche Bank): Just two questions: The first, Dr. Bock, is the same question I asked you actually at the full-year results and you said: Ask me in September. – So just in case you forgot the question, it is: Your guidance is that margins go up, capex comes down. You haven't given any special cash return or anything like that, you have done no big M&A. So should we just assume you gently increase the cash thing on the balance sheet and try and be more nimble than in the past when it comes to opportunistic M&A?
The second question is more a general question: How do you actually plan for long-term investment now, given the huge volatility, not just in demand in some of your growth markets, but also in energy prices? Do you assume the shale gas advantage long-term? Where do you see the oil price going now? Do you think China will change its gas price? In the next five, ten years, how can you actually plan when your biggest inputs are going up and down 50 percent quarter to quarter?

Dr. Kurt Bock: Thank you, Tim. Let's start with capex; that's a real issue. How do you plan for a future where you have such a high degree of volatility? You are seeing it now in the US shale gas environment – where we have investment plans, obviously, which also in a certain way are a bet on the difference between natural gas and oil-based products, to make it very clear.
We do these studies very carefully. We try to be as diligent as possible. We don't want to get carried away. So we always go back to the drawing board and try to understand: Is this still relevant what we suppose to believe is going to happen? We are extremely self-critical in that respect. One way of testing our business case is essentially: You work with scenarios, which you can do. But still, at the end of the day, you have to make a decision which scenario you like most.
The ideal situation would be that an investment is robust under all scenarios. That would be perfect, but that is in most cases not reality. So you have to make choices. In one of my slides I said: We have to be flexible with regard to how we implement the strategic measures. This was essentially

alluding to this high-volatility environment. It could mean e.g. that we postpone an investment and say: It's essentially the right thing to do, but everything we see right now for the next five years is telling us: It's not the right point in time. It might still be a good point in time a little bit later. So this is an ongoing analysis. There is no perfect solution to that. But, clearly, with this changing raw material world, it has become much less predictable than at least we believed it to be predictable a couple of years ago.
M&A: We always try to be nimble and fast and speedy. Our M&A decisions are not driven by our balance sheet, to make it very clear. You know this. The fact that we have a little bit more cash on our balance sheet or less debt level wouldn't lead to a Board discussion: What are we doing now? Is there really a great company to buy which we have not seen before? That is not the way how we do a strategic analysis.
We have a list of companies we follow very closely – as our competitors do as well. We try to find out, what are the pros and cons in terms of integration synergies? Are we really the better owner at the end of the day? That is really the underlying question: Are we really the better owner of that business? What does BASF bring to the table when we acquire a company? What would we do differently than the previous owner which would really then drive value? Then we look at the balance sheet and ask ourselves: Okay, is the money available? That is the way we do it.
This is an assumption: If really now we would have a period of increased cash generation as you alluded to, we will find a solution for that. But we will not make any foolish decisions in terms of M&A.

Jeremy Redenius (Sanford C. Bernstein & Co.): A couple of questions related to capex, the first one: Have you done a look back at the capital projects that you have executed over the last, say, three to five years, just to understand how well those decisions were made? Have you made any changes to your capital approval processes as a result of that look back?
Second, just specifically on the methane and propylene project in the US: What are your latest thoughts about that?

Kurt Bock: Jeremy, MMTP: We are in the engineering phase, we are doing the detailed engineering which is quite a lot of effort because it's potentially a big project. But as we said before, in 2016 we will look then at the entire situation which is essentially a set of predictions we have to make about the different product and raw material prices. Then we know in detail the engineering and construction cost and then we can make up our mind whether we like it or not. At this point in time it's pure speculation.
What I can tell you is: If this current situation continues in terms of a relative advantage of oil versus natural gas, it would be a little bit of an uphill battle. But then, again, you have to make a prediction about the long-term price development of oil. I hope we will be smarter in that respect six or twelve months from now. That is the idea.
Capex: We have a very thorough procedure in place where we back-test so-to-say all our projects which have been approved and have been implemented. So there are a couple of internal audits, economic audits where we try to understand whether we hit our economic targets. And if not, what are the reasons for over performance or under performance? This is a very thorough process. We try to learn from that.
When we fail – I am not saying, we are doing everything perfectly – it is probably 90 percent about misreading the market in terms of timing. Technology: We normally get it perfect. Construction: There might be some surprise from time to time. For instance, we had a situation in Chongqing – you are aware of that, where all of a sudden we had to change our raw material base, but yet the team did an excellent, great job in bringing the project in time, no sorry, in budget, but a little bit delayed because there was this change in the natural gas situation.
But the most difficult thing to predict, obviously, is the market. I talked about Brazil.

Overall, we have not changed our set of KPIs because they work. It's less about the methodology, really more about the assumptions you put into the models. That's something we constantly ask ourselves again and again: Is this still the best case? I already talked about the scenario planning which we are doing here as well to test projects against very unfortunate conditions, put it that way, and whether they are still viable under those unfortunate conditions.

Andrew Benson (Citi Investment Research): I think, it was 2012, at the HAC in London, you talked about the shift to a high proportion of your business in solutions, move away from commodities. You have talked here about perhaps a faster pace of commoditization and you have talked about specific discrete capex projects and increasing the proportion of your assets in Asia rather than shifting downstream or towards more solutions provider. So I wonder if you can give an update on that industrial philosophy.
Secondly, have you looked at whether it would be advantageous for shareholders to spin out Wintershall in total and whether, given a lower price environment and perhaps the need for oil and gas consolidation, it might make more sense for those two assets to be separated and deliver value and aggregate to shareholders?

Kurt Bock: Let's start with Oil & Gas: This discussion is not a brand-new one. Actually, it has come up for many, many years. There is probably not a single year where not an investment banker comes to the Blue Book and says: Okay, how about Oil & Gas? Can we talk about it?
I know that some of you are a little bit critical with regard to having this relatively broad portfolio, Oil & Gas and Chemicals within one company. You are basically saying: Okay, I can do this kind of diversification myself if I want to. Yet I think I have talked about the hydrocarbon hedge which is important, which works. I also talked about the way how we run Oil & Gas, which is really ensuring a high rate of return, ensuring strong free cash flow. And we have the ability to do that essentially by tailoring the investment portfolio, the capex portfolio in an ongoing fashion. That has worked very nicely.
I also think we have been able to develop that business over the last couple of years quite successfully. You will have a special session on Oil & Gas with much more detail where we will also talk about the separation of E&P, exploration and production, from gas trading. As you know, we have achieved an agreement with our partner Gazprom in that respect. So I think we are developing the business in a right direction. In terms of sales, by the way, it will be much, much smaller. We lose about 12 billion in terms of natural gas. Today, it is – I wouldn't say: inflated because it is a trading business, it's the nature of the business, but it looks bigger actually than it is. I think Wintershall has benefited tremendously from being part of BASF because we provide financial clout and political support in getting things done. This has worked quite nicely. So at this point in time, we don't really feel that this business doesn't fit into BASF.
Even if you hypothetically now would say, it could be a good idea, then you have to have a very strong opinion about the oil price. Right now, we are at about 50 USD per barrel. As I said before, it's supposed to go up, but if you tell me when it's going up and how fast and how steeply, I would be extremely grateful.
Your third question is a complex one. We have a clear strategy to strengthen our downstream businesses: Functional Materials & Solutions, Performance Products. I think we have done this quite nicely. When you look at Functional Materials & Solutions, I talked about the investment projects, but you will learn much more today and tomorrow about the specifics of that business. It's really all about R&D, customer-driven projects, bringing something completely new to the customer and these businesses grow very nicely and are possible due to our strength in R&D.
In Performance Products, we have a huge diversity of products actually. It's a big operation and Mike Heinz is here and he will talk about that business as well. We have acquired a couple of businesses over the course of the last ten years in that specific field. Some of those businesses have developed very nicely. We have achieved tremendous progress. Other businesses need a

little bit of attention. You have seen quite some restructuring in that segment of BASF, which is ongoing, which is, in a certain way, the nature of running a chemical operation because, again, as we speak products commoditize, there are better owners available and we make a decision to sell. To give you one example: We have a relatively successful pharmaceutical business, custom synthesis essentially, which has developed quite nicely over the last couple of years. Yet, in terms of size, critical size from a group point of view, and best ownership we can draw the conclusion: There are better places to put it. We sell it now to a Swiss company called Siegfried. We want to close this very soon from now. This has been a good deal for BASF, most probably also for Siegfried and also for the employees of that business.
So this kind of pruning and adaptation will continuously go on. I think the underlying question in your case is: Will it shift really the ratio of differentiated commodities to Performance Products and Functional Materials & Solutions? This is our goal. You see a certain shift. Yet, with relatively large investments in some of the commodity businesses, these businesses also grow. They are supposed to grow in emerging markets because they very often are the first phase of going into the market and then, building on those more commoditized products, you go down the value chain and establish differentiated products as well – which we do, as we speak, in Asia e.g. in terms of catalysts, coatings, but also light-weight materials. This is a kind of a lifecycle in terms of investment going on.

Norbert Kalliwoda (Dr. Kalliwoda Research): Mr. Bock and Mr. Engel, you told about your operations in Siberia, the gas operations. In Alaska, in North America, there are some new operations or explorations. Are those markets interesting for you, for the future maybe?

Hans-Ulrich Engel: In Oil & Gas we have, from a regional perspective, a clear focus. We are in four core regions plus one so-called development region. I am very happy to explain that in more detail in our afternoon session. There are no plans to venture into America, i.e. North America or into Alaska.
Kurt Bock: We also know our limitations. We know our strengths, but also our limitations.

Paul Walsh (Morgan Stanley): I have two questions: How should we think about the ramp of the capex projects? There is an awful lot coming through the system 2015, 2016 and probably 2017. We talked a lot about what you are spending the money on, but in terms of the impact that is going to have on the business: There are some big projects going live now. Do we see an acceleration coming through in some of that investment-driven growth?
And to what extent do you feel comfortable or confident that in 2016 you can get back to the sort of overarching targets of growing above chemical production, i.e. above 4 percent volumetrically with higher margins? Are those two sort of intrinsically linked?
I also noticed there are no real comments around the current 2015 targets, but I assume that means that there is no change to them. So I just want to check on that as well.
Kurt Bock: Thanks, Paul. Talking about 2015, at this point in time we have nothing to say with regard to our expectation for 2015. The market environment is not an easy one, to make it very clear, but at this point in time, from what we see, nothing new to report.
Organic growth: Yes, the investments have the purpose to create growth and profitability going forward. I did not say that we will achieve this growth rate of growing slightly above market with organic growth only. It always has been a combination of capex plus a net effect of acquisitions and divestitures, and that will be the case for the future as well.

Paul Walsh (Morgan Stanley): You gave some guidance on the costs relating to the ramp-up of projects this year. Is there anything worth flagging for next year as well?

Kurt Bock: This year, as we discussed earlier this year. Next year, I think, it's a little bit too early. I think the easy answer would be: We haven't started the budgeting process for 2016 yet. We are still focusing on getting things done in 2015 – which keeps us busy, frankly.

Christian Schlimm (Allianz Global Investors): What cost of carbon do you bake into your investment decisions for the next three to five years?

Kurt Bock: I don't think we say that number, actually. It is much higher than what you can read in the papers currently, in the European Emission Trading System. The real question with regard to ETS is how the system now will be changed after 2020, 2021. That is an ongoing discussion in Europe which is a real concern to us. Everything we have seen and heard so far means that the technological hurdles will be very difficult to overcome.
To be more precise: Currently, we have a rate of improvement in terms of energy efficiency of something like 1.7 percent, based on the current goals. If the new goals, 40 percent, come into play, this rate of energy efficiency improvement will go up to 2.2 percent. It doesn't sound a lot, 0.5 percent, but it's a lot. Industry normally can achieve something like 1 percent. So this is above the rate of technological development. Therefore, it could become a real burden for the entire industry. Then there are lots of questions about carbon leakage and who is included and who is not. This is an ongoing discussion with the European Commission. It's a very serious topic for the entire industry.
As I said when I talked about China, the good news is: If – really if – other parts of the world also introduce carbon trade, it could create a more level playing field, although the newest proposal from the European Commission foresees that we would not be able to use credits which we have e.g. in other parts of the world for Europe – although that would make a lot of sense globally because emission trading is a global issue and not a regional one.

Laurence Alexander (Jefferies): Can you flash out a little bit where you see niches or areas of pent-up demand that will drive the reacceleration later in the decade from the current choppy environment?
Around your comments about absorbing the excess capacity in the next few years, does that imply that by 2017, 2018 you should be making decisions on the next wave of capex upcycle? Shall we be thinking about that for 2019/2020?

Kurt Bock: Second question first: I am not sure that's the way how we operate. We look at markets and businesses and try to understand how we are positioned, what the future outlook is. And then we try to understand whether it makes sense to invest. Very often, investment is not the first choice. It's a debottlenecking e.g. or just a change in specifications. So investment is not the first and foremost purpose of this company, to make it very clear. This is a tool to achieve growth and profitability.
We come to that decision point which you describe then maybe in 2016/2017, but really, it's an ongoing discussion and analysis: Where are we and what would it mean for our investment budget, but I can tell you, we have many more proposals on our desk for future investments and capex than we, as a Board, would like to see implemented and also much more than what we would think is financially viable. So there are many ideas constantly generated within BASF and part of our job is essentially to say no. Saying no is a very important skill sometimes.
Areas of growth: I think it is helpful when you look at the slide where we have shown the start-ups in the last and next couple of years. It clearly highlights where we would like to see growth. This

should help us to grow, not just in Asia. I cannot give you specifics in terms of which product and which country, but I am pretty sure: Today and tomorrow you will learn more about that when you really do the deep dives into specific businesses. You get a much better feeling what's really behind this kind of summary presentation which we have been giving here today. I think this is more helpful then.

Christian Faitz (Kepler Cheuvreux): Dr. Bock, you mentioned before, Asia is currently running on three cylinders. I believe one of your key customers was running very well on four cylinders, in 2-liter TDI engines up until last week. Can you comment on, as a first assessment from a top level, how, if Volkswagen was to lose market share that would affect your sales? Would you maybe potentially even benefit in the longer run via SCR catalysts etc.? How exposed are you to Volkswagen? Can we get any feeling on that?

Kurt Bock: You won't be surprised if I tell you that Volkswagen is a big customer of BASF. We are very proud to be a supplier actually, a strong supplier of them. Whatever we know about the situation we know from the press. So we don't know more than all of you. We analyse what is going on.
What I can tell you here is that the technologies are available to cope also with the US emission standards. That is already existing today. We have a very good business in catalysts providing these tools. Coincidentally, today I talked about the copper/chabazite catalyst which is exactly aiming at NOx reduction which is a big topic for diesel, as we know.
So the tools are available. Catalysts is a competitive industry. It's an industry based on innovation. You will also learn more about it today and tomorrow. We have to see whether this translates into a net increased demand for these technologies which we provide. I cannot rule it out, put it that way. Everything else, I think, at this point in time is really pure speculation.

Jaideep Pandya (Goldman Sachs): I have two questions. The first one is: If I look at the 2010 to 2015 period, your EBITDA growth has been around 2.5 percent, so below your sales growth, what you have shown. This is a period where oil prices were around 96 dollars as an average. You have also done very well on the cost savings. So could you give us some colour why you are confident that in the next five years you will be able to increase EBITDAs stronger than sales?
The second question is going back to your production targets in Oil & Gas: If you do achieve 190 million barrels of production in Oil & Gas, could you shed some light on the hydrocarbon hedge? Does this mean that you will become a net long oil company?

Kurt Bock: I take this second question about the hydrocarbon hedge. I made one observation which is really about the proportion of natural gas versus oil production. We produce more natural gas than oil. Oil and gas have different price dynamics. In our production we are more natural gas- than oil-based. In that respect, the pure comparison of million barrels is not perfect. You also have to look at the composition. But your observation is probably right: If we get to the 190 million, we might be slightly long in oil. One way of coping with this is to grow the chemical business as well, faster.

Hans-Ulrich Engel: Quickly on your question with respect to EBITDA growth in the timeframe 2010 to 2014: As I tried to explain already during my presentation, we have seen these exceptional years 2010 and 2011, coming out of the recession with very strong earnings growth during that period of time. We have seen, following that, beginning in 2012, from a margin perspective on the chemical side, let's say, overall weaker environment. So we have seen a small downturn there. And you have to keep in mind that, as a result of the capex program, we have slightly higher fixed cost that come with new plants which are not yet fully utilized. So you should see that working itself through the system over the next years.

Bin Xiao (Polaris Capital Management): A quick specific question on coal-based projects in China: Can you comment on – as a big picture – why coal-based projects can be a sustainable solution? And also: Why can't this concept be applied outside China?

Kurt Bock: That's a great question actually. Coal has a sustainability challenge, there is no doubt about it, in terms of CO_2 emissions and water consumption. Yet it's being a very, very economic raw material base. The net-net for the Chinese government is, they push coal.
For us, this poses a real dilemma because we have clear sustainability targets. On the other hand, we also have to make sure that our raw material base in China is competitive. There is technology available, which is state of the art, which is better than what we have seen in the past. For instance, syngas plants based on coal can be quite efficient actually, syngas for large chemical sites in huge quantities. There might be opportunities to selectively improve our cost base.
What I don't foresee is that – to make it very clear actually – BASF would enter into a completely new coal-based site somewhere in Asia to have a kind of Verbund-driven production there. I don't see this happening because the challenges are huge to make this sustainable.
And on top of that now comes a new – President Xi announced it – emission trading system where we don't yet have the details, but we have to assume – if they are serious about it, and they create the impression that they are serious – that this will also affect the relative advantage of coal versus other raw material sources.

Oliver Schwarz (M.M. Warburg): Just two remarks from my side: Compared to the last strategic update meeting we had, your targets seem to be a little bit less quantitative than they were last time. I guess that's mostly due to the volatility we saw and changes in the market. But judging from your target "sales growth slightly faster than the global chemical production", given the idle capacity you have on your hands, the capex projects coming on stream over the next two years and your assumption that raw material prices, e.g. the crude oil price, will go up again, it's just a question of time – what is it that holds your sales growth back in comparison to the global chemical production? Is that only due to the large expansion in the US or are there also other components that I might be missing?
Secondly, just quickly on the hydrocarbon hedge: It seems to me, judging from past numbers, that margins in the chemical business and in the Oil & Gas business used to swing in tune, so there is not too much on a hedge basis when you are talking financials. So it must be all about the availability of hydrocarbons to your chemicals when talking about hedge. Has there been any case of your not being able to source from third-party sources or suppliers over the last ten years, so you really had to rely on your own production, so you didn't run into a bottleneck?

Kurt Bock: I think we never said that we need Oil & Gas to really have the physical supply for our chemical production. I think that would be ludicrous. These are very liquid markets and you can buy the stuff if you need it and wherever you need it. Yet, the hydrocarbon hedge has an economic effect. It is correct: In a certain way, it swings in parallel, depending a bit on the underlying reasons for the price developments. If the underlying reason for a weak oil price is lack of global demand, essentially meaning lack of global growth, then you will see a very parallel development. If the reason for an oil and gas price decline is simply oversupply, then you see a somehow different environment. This year, it's hard actually to say what the real situation is. It feels like there is oversupply. Yet, it also feels like there is a little bit of slowdown in overall growth, especially when you talk about emerging markets.

So physical availability has never been an issue, will not be an issue. It's a good business for BASF to run and Hans will talk about it in more detail later today.
To sum it up here for this session: We think that these targets are very, very challenging to achieve. The growth target is especially challenging because, clearly, we have a different regional footprint than the global chemical market. We have more business in a low-growth area, namely Europe, than when you look at the global chemical market footprint. That is certainly a challenge. So we need a little bit of improvement in Europe and the United States as well. Asia will grow a little bit slower than in the past. This might help relatively so-to-speak.
And in terms of earnings we equally think that our target here is maybe not a "Punktprognose" in good German, but it is directional and it gives you clearly an understanding what we try to achieve and what is our aspiration level.