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BASF 2nd Quarter 2015 Analyst Conference Call

Transcript - Q&A Session by Topic
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1. Group

Paul Walsh (Morgan Stanley): On capex: Can you just remind me where you are with capex? Obviously, we have seen a number of adjacent industries cutting capex quite aggressively in the face of a global growth environment that looks to be a little bit weaker. What are your intentions around capital investment? I know there are probably a few other things than organic capex in the first half, but I did notice that your total spend was up year-on-year.

Kurt Bock: Capex: We are cutting back this year compared to last year. We have guided you that there should be about a 1 billion euros reduction in capex. As it looks right now, that reduction might be only half of that 1 billion euros for essentially two structural reasons, one is simply the exchange rate, the stronger dollar which really impacts our capex which is then denominated again in euro later on. That is about half of the deviation.
The other one are non-operated oil and gas fields where we are not in the driver's seat, actually, to determine how much is spent and how fast. This is very often in the oil and gas business more a timing decision than a decision about the actual total spending. In some cases we have seen now with the costs of rigs etc. coming down that it might be sensible even to accelerate certain projects. That had been the case. But, again, in these projects we are not in the driver's seat. We are simply handed the invoices by our consortia leader and we have to recognize this in our accounts.
So capex will come down a little bit less than what we had expected earlier this year, essentially currency-related and due to Oil & Gas.
Going forward, given the market circumstances, given the high level of investments which we have made over the last couple of years, it's quite clear that we will have a very, very strict capital discipline.

Paul Walsh (Morgan Stanley): Can you just quantify what the FX impact was on EBIT pre special items in Q2? What did it add to EBIT? That would be helpful.

Hans-Ulrich Engel: Paul, I am addressing your question on the FX impact on EBIT in Q2. As you know, we have got quite a basket of currencies. The US dollar predominantly had a very positive impact as a result of the euro weakening. But then we also have currencies which are quite important for us, like the Brazilian Real, the Norwegian Kroner and the Russian Rouble. If you take all of these currencies, the positive impact is in the order of magnitude of roughly 250 million euros in Q2.

Jeremy Redenius (Sanford Bernstein): I think depreciation & amortization jumped quite a bit year-over-year in Q2. Can you talk us through why that is? I am wondering, is that a sign of the start-ups that are coming through and perhaps that leads to better sales in H2?

Hans-Ulrich Engel: That's clearly the result, you know, that we ramped up our capex program starting in 2011. A number of plants that came on stream already last year, like the new catalyst plant in Poland or our new site in Dahej in India, all of these came on stream in the second half of 2014. A number of additional plants came on stream in Q1 and Q2 of this year. And that then leads to the increase in depreciation and amortization.

Jeremy Redenius (Sanford Bernstein): Is that largely falling in Chemicals businesses or is Oil & Gas a major part of that as well?

Hans-Ulrich Engel: It's predominantly upstream in Chemicals, but also in Oil & Gas. Keep in mind that in Oil & Gas we also did the acquisition of additional assets from Statoil. That closed in Q4 of last year, so we didn't have that depreciation and amortization in our P&L in the first half of last year. So when you compare, yes, Oil & Gas also plays a role there.

Laurence Alexander (Jefferies): Could you quantify how much of the drag on your EBIT was the inventory reduction in terms of higher fixed cost absorption?

Kurt Bock: 200 million euros plus.

Andrew Benson (Citi Investment Research): Could you also explain why you were destocking as much as you were? Normally, it's towards the year end rather than mid-year.

Kurt Bock: Destocking: When we started into the year we simply had the impression that our inventory levels might be a little bit too high compared to market demand. For that reason, we put the foot on the brake, so-to-say, and deliberately reduced capacity utilization rates. That obviously leads to higher idle cost. It improves cash flow, by the way, which we have seen in Q1 and Q2, but this was, I think, a necessary measure in light of a relatively soft market environment which we have seen. In a certain way, it's a one-off, but it's necessary. And we don't really do it to the end of the year. This is an ongoing task which is a big priority right now for our operations.

Evgenia Molotova (Berenberg Bank): How were your capacity utilization rates affected by the inventory reduction. Can you comment on where most of the inventory reduction happened and what trades you have now? Do I understand it correctly that it is mostly in Performance Products? Can you comment on the utilization rates in Chemicals, Performance Products and Functional Materials?

Kurt Bock: Capacity utilization rates: I beg your understanding, but we don't really provide a percentage because we have such a diverse portfolio across the board that one single number doesn't really make an awful lot of sense.

The inventory reduction measures were across the board. There was some seasonality built in, as Hans mentioned. But all businesses – which is important to us – contributed to this working capital trimming exercise.

Anthony Jones (Redburn): The auto industry, as you have indicated, has been very strong. But we are picking up from other suppliers into the same industry that they are not as upbeat about what's coming in the second half of the year. So how do you see the cycle evolving?

Kurt Bock: Auto: Yes, the growth of the automotive industry this year is probably something between 2 and 3 percent. That is not really breathtaking. Still, Asia grows faster – which is good news. And the United States has achieved or will probably achieve this year a new record again, after about ten years of very low growth and sometimes slumping demand.
We share that feeling that caution is advised for the second half for the overall market situation. However, you have to keep in mind that every company has its own competitive positioning here. At this point in time we have made good progress in, I think, enlarging our share with major customers. Those customers also seem to have sometimes higher growth rates than the average market. Insofar, this is not risk-free what we are seeing, not at all, and we are not just assuming that the first half is a proxy for the second half, but we are cautiously optimistic for the automotive industry.

Neil Tyler (Redburn): Just one sort of aggregating question from me, please, just to make sure that I have understood the various comments you have made around costs in the quarter.
As I understand it, you said that there were approximately 50 million euros of costs associated with the new asset start-ups, a roundabout 200 million step-up in fixed cost as a consequence of inventory reduction, then some more, on top of that, with a relation to turnarounds. In my mind, I have got a number of perhaps 50 to 100 million. Is that a correct understanding?

Kurt Bock: Neil, that is pretty much correct. Compared to Q2 2014, we had higher costs for turnarounds, that were in the order of magnitude of plus 50 million euros.

Neil Tyler (Redburn): Okay. – The second part of the question is: In Q3, how much of that do you expect to be repeated?

Kurt Bock: That might be the same order of magnitude. Inventory reduction measures – that needs to be seen whether we will add.
In terms of turnarounds it is pretty much the level of last year, I would say.

Anthony Jones (Redburn): What would be the trigger for you to start to think about more significant initiatives to trim back on costs and raise that cost-saving target from your current targets this year?

Kurt Bock: On cost savings: I mentioned the STEP program which we will conclude by the end of this year. Actually, as you know, we had increased the savings from 1 billion to 1.3 billion euros about a year ago. It's quite clear that this will never stop. We have to think how to communicate with you what will be next. But you can safely be assured that the cost trim within BASF is a continuous task and there is no reason to relax at all. At this point in time we are already thinking about the next possible steps how to improve further on.

Mutlu Gundogan (ABN AMRO Bank): How has the demand evolved throughout the quarter? Did the quarter start out well? How was the end of the quarter? How has the third quarter started?

Kurt Bock: I think that is an important point – thanks for the question. It is a very interesting pattern we have seen so far this year. We had a, frankly spoken, pretty slow start in January, February. Then March was a very good month. We had again a relatively slow start into the second quarter, with April and May being kind of okay, but not really impressive. Then, to the end of the quarter, volumes recovered and growth accelerated a little bit.
The big question is now: Is this really a pattern or is it just coincidence? The only thing I can say: We are now starting into the low season, especially in Europe. It is very hard to predict how July and August will be. The real question is then, obviously, September when everybody is going back to school, so-to-say, and the factories are starting up again. That is very difficult to predict.
Overall, we have seen – I think I mentioned this – relatively sluggish demand across the board in some of our major markets.

2. Region Asia Pacific

Lutz Grueten (Commerzbank): One question on Asia and especially on China: The operating margin in that region is down to 1.4 percent. You might help us with some trading updates here on the region. What's your current feeling there in the region? Maybe you could give us also a break-down: What of that margin deterioration is one-time and what is really market-related?

Kurt Bock: Performance in Asia is not satisfying, that is for sure. We had a weak Q2. We have a mixed picture actually. As we explained earlier already, everything which is related to the automotive industry develops very nicely. We have good volume growth in that respect. You know that we are investing heavily in that space: catalysts, coatings etc. We will continue to grow that business. Even in view of the relatively lower growth in the Chinese automotive industry compared to last year we see good reasons to be optimistic about that business in China and in Asia.
Where we got hit, obviously, is everything which is cyclical, supply/demand-driven in China. Margins have come down for acrylics. They have come down slightly for MDI. That certainly is a drag on our performance. That is the major reason why we are where we are right now.

What I would like to add here is a note of caution because you only look at the regional EBITs, the regional earnings which we publish. Obviously, we also have a relatively strong export business from North America and from Europe into Asia which adds considerably to our overall earnings in the Asian markets. That development was quite positive, actually, but our operations on the ground, especially in the upstream, are not delivering at this point in time – which is made even more difficult because, as we said before, we have a couple of start-up costs in China with new plants coming on stream.

Christian Faitz (Kepler Cheuvreux): Can you please quantify those sales you alluded to, that are geared from NAFTA and Europe into Asia?

Kurt Bock: Actually, we never have done this and we will not start talking specifically about what we call pre-profits which we make exporting into those regions. The only message I try to convey is: Yes, we had a considerable earnings decline in Asia if you take into account the full picture. What we have not just produced in Asia, but what we also exported into Asia and where we have pre-profits the picture looks better. Still, we are not satisfied, to make that very, very clear.

Peter Clark (SG Corporate and Investment Banking): It's going back to China. In the commentary you talked about the volumes being flat, obviously, in Asia. China is still growing. I don't know if that's the first half or the second quarter.
In the past you made it quite clear: The Chinese margin is better than the rest of Asia. I am just wondering if that was still the case in the second quarter.

Kurt Bock: What we have said in China specifically is that our petrochemical margin seems to be better than what our competitors produce in China. That is a very, very small relief, I have to say, because the absolute level of the margin is absolutely not satisfactory. For instance Nanjing – the entire site there had a major turnaround, which was completed in six weeks on budget and on time – is producing positive results, but not at a level where it needs to be. We seem to perform better with these sites than some of our competitors. But, again, we are not satisfied with the absolute level. I think that is the message which I tried to convey in the past as well.

3. Segments

3.1 Chemicals

Laurent Favre (Bank of America Merrill Lynch): On European cracker margins, there has been a record season in the first half of force majeure and then shutdowns, one of them in Moerdijk which restarted.
Can you talk about your view on margins for the second half? We started the year with you basically saying that there could be a short-term benefit, that in the long run those margins would be driven by supply and demand and demand has

not been exactly good. So should we assume that margins decline in the second half?

Kurt Bock: In Europe, margins have been good. It is probably fair to assume that there might be a little bit of a softening going into the second half. The big question is always: When does it start? Frankly, every good month is a really good month in the cracker business in Europe right now.
In North America, based on also publicly available data, we assume relatively stable margins going forward. The volatility in Asia Pacific is certainly the highest one. That makes forecasts very, very, challenging.
On top of this – what you mentioned is very important – we have seen a couple of force majeures and turnarounds in that industry which, obviously, are very difficult to predict. Sometimes it just happens. But overall: That cracker business has been a good business in the first half. We are slightly optimistic for the second half.

Laurence Alexander (Jefferies): Can you talk a little bit about polyurethane trends heading into the back half of the year?

Kurt Bock: We have seen some margin squeezing in Asia. I think I alluded to that. Our MDI plant in Chongqing is coming into the market, which is certainly an interesting experience in a market which is slightly long at this point in time.
We have a situation in Europe where margins are not where they are supposed to be. And we will start up now the TDI production here in Ludwigshafen against the background of a market which is consolidating. There are competitor quantities, capacity which is also taken out of the market. And you know that when we will start up Ludwigshafen we will more or less simultaneously shut down our 80,000 tons in TDI in Schwarzheide, which should essentially help to balance the market in Europe.
So, essentially, going forward we see a kind of flattish price/margin development.

Peter Spengler (DZ Bank): You mentioned the new TDI plant before. Could you update us on the progress with the TDI plant in Ludwigshafen? Is there a delay? Did you consider ramp-up costs already in Q2? What can we expect for the second half of this year?

Kurt Bock: Start-up will now happen in Q3. Essentially, there is a slight delay. That is correct. We will incur higher start-up costs, obviously, than in the second quarter, especially in our Chemicals segment and, more specifically, in the Monomers business where you have TDI,and MDI. On top of that they also have a couple of more challenging businesses like caprolactam where we don't invest, to make that very clear, but where we have quite depressed margins.

3.2 Performance Products

James R. Knight (Exane BNP Paribas): It's on Performance Products. Can you quantify some of the one-offish type impacts in the quarter, so the start-up cost, inventory reductions etc.?

Kurt Bock: When you look at the deviation from last year, it's about 130 million which certainly is not pleasant, but I think there are lots of one-time effects which we have to keep in mind.
We talked about the unplanned outages. We mentioned PIB in our presentation. We had some product outages, e.g. we had force majeure on ethylene oxide which also impacted our downstream businesses. We had a very strict inventory management which increased idle cost considerably, and we had some start-up cost. All in all, this accounts for approximately more than two thirds of the deviation from last year.
Apart from that, we had a couple of market developments which are not completely new, like the very lackluster demand in oilfield solutions and paper chemicals; we have talked about that earlier.
We had some pricing issues which are also well-known, vitamin E being probably the most prominent one. Now, the official price is even below 5 euros per kilogram, which we have never seen before.
So two thirds one-time, one third market-related. Let me add – because I think that is important – that we are in full swing to implement the restructuring measures which we have announced before, achieving 500 million euros earnings improvement by 2017. Everything is on track. But, obviously, the market was not really helpful in Q2, especially compared to a relatively good start into the new year when we had a strong performance in Q1.

Evgenia Molotova (Berenberg Bank): You are separating pigments in a separate unit. Does it mean that this is becoming a non-core business for you and you are potentially open to divest that?

Kurt Bock: Pigments: The decision which has been taken now is that we will form a, what we call, global business unit. So far, this business is run in a regional way. There is some global coordination, obviously, because some of those products are only produced in one plant globally, or most of them yet, actually. I think we will refocus the business and make sure that the rubber hits the road really in terms of market presence, aggressiveness in the market and growth orientation. In that respect, this global set-up will help.
We will then most likely carve out these activities into a separate legal entity, which immediately leads to the question: Is this now, as you asked, non-core and what does it mean for the future of the business? To make it very clear at this point in time: We have very high fighting spirits here and our goal is to make this a better business. We are global leader in pigments. We have some very strong parts in that business. We have some weaker spots in that business. We have to make sure that we restructure successfully, that we, as I said before, grow the business in a faster way; then we see where we are. Then we can still make decisions. But at this point in time we are very determined to make the business

better. It is a good business, but it is not really a great business. It has some structural deficiencies, which we are working on, have been working on.
With this next step now we will focus again management's attention on the most important task here and make sure that it improves further on. Then we see where we are.

Markus Mayer (Baader Bank): Coming back to the pigments question: Should we expect carve-out costs or other costs than in the Q3 reporting?
From a theoretical standpoint: A joint venture with another player, from an antitrust perspective, would this be possible?

Kurt Bock: I don't think we will have any carve-out cost in 2015. Even in 2016 there is some legal restructuring, but that is not really material from our point of view.
The second question was about possible combinations and the preconditions for that. I think this is far too early – based on what I have said in an answer to an earlier question – to speculate on this at this point in time, frankly.

3.3 Functional Materials & Solutions

Laurent Favre (Bank of America Merrill Lynch): My question is on Functional Materials & Solutions. Like in Q1, it looks like the big division on improvements in earnings was really driven by Performance Materials. It looks like in there you have got positive impact from your own actions, but also positive impact from the environment, especially on raw material deflation. Could you talk about specifically those two signs?
Can you basically tell us what you are doing in terms of moving to specialties and on the other side whether or not we should be expecting some kind of normalization of the gross margin as raw material prices have tended to go up and maybe your selling prices have a bit of a lag on that?

Hans-Ulrich Engel: First of all: yes, very nice improvement in our Performance Materials business both in Q1 and also in Q2. What are the key drivers here? I would say, there are probably three key drivers. Number one: That is one of the operating divisions that sells to a large extent into the automotive industry. Automotive, as Kurt has alluded to already earlier, is doing well, in particular the OEMs that we are supplying.
Number two: It sells into the construction industry. Also there we have seen some improvements over prior year.
Number three: Yes, there is a raw material price impact. It always depends on how you shape your price formulas for the respective businesses. There is some benefit in Q2 due to the way that lags and leads work in these price formulas.
So these three aspects overall combined with another operational excellence program that we run in our Performance Materials segment help to generate these types of returns and profits.

Martin Evans (JP Morgan): Just on the construction chemicals comment which is quite an optimistic one: You talk about significantly higher volumes, especially in southern and eastern Europe. So, do you feel now at last that that market has genuinely bottomed and there is some decent restocking going on or is this maybe just a one-quarter effect in construction chemicals?

Kurt Bock: I think our comment is probably more about the performance of our business than about the overall development of the industry. Yes, we see very different environments across the world. But, more importantly, after years of restructuring and refocussing those businesses, I think we are now in 2015 on track to improve earnings. We have seen nice improvements over the last couple of quarters. We work very, very hard to continue on that path.
This is more about taking out cost, adjusting our product portfolio, adjusting our regional portfolio, focussing on markets where we have competitive advantage and where we can create value for BASF. That seems to work quite nicely right now.
This is different from region to region in that sense that we have some markets where we have very strong market positions like the Middle East – a very important business for BASF. But essentially, this is about self-help measures. That works right now.

Martin Evans (JP Morgan): Okay. Rather than sort of underlying demand then?

Kurt Bock: There is underlying growth in some of the markets. But the real question is: What is your share of that growth? I think we are in a better position today to grab a higher share of that growth than in the past. We are better positioned.

3.4 Agricultural Solutions

Andrew Benson (Citi Investment Research): Can you provide any insights into the agricultural market and how you think that will develop?

Kurt Bock: Ag: There is softness in the commodity markets obviously. You have seen now a couple of numbers also from competitors. I can only repeat what we have continuously said in the past: When you judge ag you should really look at the first-half results and not at individual quarters because it's almost a coincidence how you cut the quarters, depending on many, many shifting issues.
We had a very strong start into 2015, essentially because we had a very strong season in Europe. It was quite clear for us that this cannot continue into Q2. In Q2, we saw softer demand for our products. There are a couple of factors which, I think, affected everybody in our industry.
What is important when you look at the first half: We have been able to increase prices – very important. We have seen flattish sales, volumes minus 1 percent, which I think is quite good, at least compared to what we have seen so far in the marketplace. We had certainly positive currency effects and we had a strong EBITDA improvement as well, which is also interesting, which is another example of what Hans described earlier on, that we have increasing depreciation and

amortization in 2015 which, I think, should also be taken into account when looking at earnings.
With this, the season in the northern hemisphere has come to a conclusion very much and now we will start up in Argentina and Brazil which is very difficult to read at this point in time, I have to say. There are lots of ambiguities and uncertainties. I have spoken about the recession in Brazil, the very soft economic environment. It needs to be seen how this will develop, but from a, let's say, competitive point of view I think BASF is well positioned in those markets.

3.5 Oil & Gas

Oliver Schwarz (Warburg Research): Just a quick one on the natural gas trading business. I guess it is almost a copy-paste from Q1. Volumes up strongly, EBIT up even more. What is the reason behind that in that environment of lower natural gas prices and rather warm weather as well as – you described it – sluggish demand in overall industries? That should not lead to an excessive use of gas as a raw material or as a source of energy to the industry.

Hans-Ulrich Engel: Rightfully you say: sales up in the natural gas trading business, also earnings up in the national gas trading business. Key driver on the sales side is really the additional volumes that we sold. The vast majority are spot sales.
What we do is: We simply use our trading platform and use it to the full extent. It is a low-margin business, but still turning the wheel a few times more often helps to generate more sales and also more profit.
The exceptional increase that we have in profit – You already alluded to Q1. Same reason here: We had a price revision in Q2. That certainly boosted the earnings of the national gas trading business in Q2.
Actually, when I look at the development that we have there in the first half of the year, I don't feel sorry about that. I actually like to see that.