# BASF Q1 2016 Analyst Conference Call


# Transcript - Q&A Session by Topic
# April 29, 2016

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# 1 BASF Group

**Paul Walsh (Morgan Stanley):** Sales have obviously come down meaningfully year-on-year in the first quarter, but profit is up. So, if I look at the three downstream divisions, Performance Products, Functional Materials & Solutions and Agriculture, all reporting mid-single-digit sales declines year-on-year but, conversely, all reporting single-digit EBIT improvements year-on-year as well, my question is pretty simple: Within that framework, can you talk about where the margin beats have come from, i.e. how much do you think is down to lower material prices – and can you keep it? –, how much is down to the fixed cost saving programmes and how much is down to sort of mix and disposals within that as well? The question really is around the sustainability of the strong margins you have reported in the first quarter.

**Hans-Ulrich Engel:** As you rightfully say, a nice development with respect to the profits in the three segments Performance Products, Functional Materials & Solutions and also in Ag. As you know, the market environment has been relatively difficult in Q1. When you think about these three segments, they actually are dependent on raw materials to a lesser extent than our upstream Chemicals segment. Raw materials and the decline in raw material pricing in Q1 may have helped in this situation a little bit. But I think we also see the self-help measures that we started to implement in particular in Performance Products starting late 2012, early 2013. That's one of the explanations for the good performance that we see in Performance Products.

When you think about Functional Materials & Solutions, we actually had a situation with nice demand in the automotive industry, also in Q1. We see this reflected in particular in our OEM coatings business, but also in our emissions catalysts business. We also had a nice development overall in the construction industry, even in Asia and in particular in China – where we saw a more difficult environment in the second half of 2015 – we saw an improved situation. That certainly helped in Functional Materials & Solutions. And we have an overall good margin situation in Performance Materials, also a division that caters to the construction industry and the automotive industry.

Ag is a slightly different story. There it is, in particular, innovative products that we launched recently. In addition to that, it is self-help measures, cost containment measures that we put in place starting early in 2015 and that show some results.

To what extent this will be sustainable, I'd say, remains to be seen. As we said, what we have under our control, I think, we managed in the way you would expect us to manage it. I think that's also a good basis going forward.

**James R. Knight (Exane BNP Paribas):** Looking at the volume side of that, understanding your comments right, March seems to have been a big pickup from January and February. Predictable question: Has that momentum continued into April? Can you detect whether it's a restocking related to demand, related to the oil price or what do you think customer inventories are like at the moment?

**Hans-Ulrich Engel:** As always, the restocking, the destocking cycles, the inventories at our customers, it's very, very difficult to say where they actually are. They don't share them with us to the full extent.

I think we have explained a number of times that what we see is an order behaviour that is focused on orders with smaller lots, smaller quantities, more frequent. But then you see certain points in time where, in my words, the customer has to come back to the drinking hole. And we experienced that from the second week of March onwards.

Typically, the third month in a quarter over the last three to four years was the weakest months. Here again, we have the last month in a quarter where we see the strongest demand.

There may be another explanation for the increase in demand that we have seen from the second week on in March. That may have to do with the oil price development and with that following raw material cost.

When I checked this morning the oil price was at 48. It's not too long ago, i.e. the week of January 20th, when we saw oil prices in the mid-twenties. That may drive to a certain extent then also customer behaviour.

Your question on what we see in April: Based on what we have so far, which are our daily sales figures – we obviously do not yet have the full analysis, i.e. volume figures and the like. But it looks like the good demand that we have seen in the second half of March continues also in April. When I look at our order book that also reflects that.

**Anthony G. Jones (Redburn):** You guys speak of cost control in the quarter. If I add up R&D and SG&A, it looks like that core opex was down about 4 percent year-on-year. So my question is: How much of this could reoccur? In this quarter, could you maybe split up how much came from currency effects and also what the total growth cost savings were in Q1?

**Hans-Ulrich Engel:** There is an impact on our cost improvement that's coming from currency effects – on the mentioned SG&A and R&D expenditures around 50%. Actually, Q1 2016 is the first quarter since, if I recall that correctly, Q2 2014 where, from a sales perspective, we have currency headwind. But that obviously then also comes with some support on the cost side. But that is relatively small, compared to the impact that's coming from our various measures addressing fixed cost. You are aware of the programme that we have in Performance Products. You are aware of our BASF Group-wide programme which is called DrivE and you clearly see the impacts of that.

Yes, SG&A cost is slightly down, R&D cost is down by 19 million in the quarter. Expect us to have a very firm grip on fixed cost development as we normally have.

**Andrew G. Benson (Citi Investment Research):** Are there any costs that have been absorbed within the EBIT in the first quarter, so restructuring, start-up costs? Can you just give us an update on what those are likely to be in the full year and that are absorbed within your ongoing adjusted EBIT number?

**Hans-Ulrich Engel:** On start-up cost, we said at the February call that we have about the same order of magnitude of start-up cost in 2016 as we had it in 2015. We also said that we saw the peak of start-up cost with more than 100 million in Q4 of 2015. From there, we will see a gradual decline of start-up cost during the course of the year 2016. So that, Andrew, should give you an idea on what's happening with respect to start-up cost.

## 2 Cash flow and tax rate

**Lutz Grueten (Commerzbank):** The cash flow: I don't want to be too picky on a quarterly cash flow, but just coming back to the effects on the working capital and the free cash flow, just the 45 million after Q1: I understand that there was a one-off situation last year and there is a base effect, but it would be great to get here also some grip on what you think the working capital will be in the second, third and fourth quarter. Year-end working capital: Should we assume that this will be similar to year end 2015 or will there be other effects throughout the remaining quarters?

**Hans-Ulrich Engel:** Lutz, that's a pretty loaded question. I think we will take that maybe in three parts. Part one: I'll address high-level cash flow and then Marc will go into a bit more details – part two. Part three: After Marc, I will talk about working capital development in general.

In cash flow, what you see there in general is what I call the new seasonality. As you know, we divested the gas trading and gas storage business, which had high cash usage at the point in time when we filled the storage capacity, i.e. Q3 and Q4, and then high cash inflows in Q1 when we sold most of the gas. That's something that we need to factor in.

I think I remember your question from last year's call which was: Would you be able to repeat cash flow development as we have seen in Q1? – Back then, I think I said: That will be very difficult. With this seasonality change that we have in the portfolio you see the outcome of that.

Marc, can you shed a bit more light on cash flow development there?

**Marc Ehrhardt:** As probably you have already seen: The effect comes from the change in net working capital. As Hans has also said: You are going to see a new seasonality in our cash flow. We are going to have less inventory buildup from our gas storage business before the heating season and then, obviously, no release of those funds as the winter draws to a close.

What we do have in the first quarter is a seasonality in the increase in accounts receivable. That will stay. That's where we go into the high season of our selling season in the Ag Solutions business in the northern hemisphere. So that remains as it is.

If you just look at it from a very high level, we are now at a depreciation level between 900 and a billion. That came from our big investments that we have done. We've told you that we are going to reduce our capex. So that's going to come down from the level that you have seen in the past back to our normal level of investment. So that built our countering situations.

Then, we have a lot of movement that should not be repeated in the net working capital, especially coming out of the movement that we attribute to the release of funds or consumption of funds in long-term incentives. Those are all numbers that will not swing that way and in comparison to 2015 return to a normal level.

**Hans-Ulrich Engel:** Then, Lutz, your third part that I wanted to address is inventory development. You saw us bringing down inventories quite a bit during the year 2015. The balance sheet position was at 9.7 billion at the end of 2015. At the end of Q1, we are at 9.6 billion. What's going to happen there? We told you that we are managing our working capital and in particular our inventories with a high focus, have shown that in 2015. What's going to happen there will also depend on what we will see with respect to raw material pricing. There is clearly a raw material impact on our inventories that helped us to bring the balance sheet position down in 2015. We will now have to see what's going to happen with raw material prices in 2016. But the clear target is to keep managing our working capital and our inventory in particular as stringently in 2016 as we have done that in 2015.

**Christian Faitz (Kepler Cheuvreux):** Can you please explain the technicality of the Norwegian tax system? That seems to be one of the key reasons why your group tax rate was at such a low level in Q1.

**Hans-Ulrich Engel:** On the Norwegian tax situation: Yes, in fact, that is a key contributor, that is *the* contributor to our very low tax rate of only 15.4 percent in Q1. What's happening there? Norway taxes the hydrocarbon income at 78 percent. We had profits in Q1 2015. We don't have profits in Norway in Q1 2016 as a result of the extremely low oil prices and also natural gas prices.

In addition to that, there is a peculiarity that has to do with deferred taxes. The Norwegian kroner has appreciated quite a bit between the end of 2015 and the end of March 2016. That led to a reduction in deferred taxes, in other words: an accounting event that you see there, no cash impact, but in combination it leads to this significant reduction in our tax rate which otherwise would have been in the range as expected by you, which is in the mid to upper 20s.

# 3 M&A criteria

**Laurent Favre (Bank of America Merrill Lynch):** My only question is on the M&A theme. I think that we were asking you two years ago, three years ago, every time on conference calls, you were pointing to high valuations in the sector preventing you from having a look at M&A and focusing on organic capex. Obviously, valuations have gone up since then. It has been a seller's market. You have been selling very well. So, I am struggling to understand now the shift of tone certainly in the press, e.g. in the interview that Kurt Bock gave to the Handelsblatt, on the will to do M&A. Could you maybe just put in a frame for us your thinking right now on acquisitions and especially ones that could be bigger than what we have seen on Pronova and Statoil etc.?

**Hans-Ulrich Engel:** On M&A: I think we have been very consistent there in what we said and we didn't only say it, but we were also consistent in our actions.

Now, is there a change in the tone? I know Kurt's quote that you are referring to, but I would not necessarily describe that as a change of tone. I think we always said that if there are interesting opportunities we would certainly look at them. We have put that in the context of our acquisition criteria. I think we came to the conclusion that at least bigger transactions than the one that you just described with Pronova BioPharma as an example or Becker Underwood, we did not see that that would have a) met our acquisition criteria and would have b) been seen as being attractive for BASF. I think you can assume that this will be the same also in the future.

**Laurence Alexander (Jefferies):** In terms of the portfolio shuffling that you have been doing – to come back to one of the earlier questions – has your thinking changed around the sustainability of technology barriers to entry and therefore the need to have other competitive advantages including vertical integration to justify staying in businesses? Or are you applying the same assumptions, but just a different sort of growth assumptions and market dynamics?

**Hans-Ulrich Engel:** I think, Laurence, our approach and our criteria for acquisitions have not changed. I actually don't see that they will change. You are absolutely right: The growth environment is slower than what we had expected three or four years back. But I don't see that there is a need to change our acquisition criteria.

**Peter Clark (SG Corporate and Investment Banking):** There seems to be a step-up in the portfolio focus in recent months. Particularly downstream, obviously, we have seen a few deals, particularly in Functional Solutions. I am just wondering if that is something that we should expect with pace to continue. Obviously, there is a very big portfolio, particularly in Performance Products actually. Certainly some of the comments in the press have indicated that you seem more focused at looking at the portfolio.

**Hans-Ulrich Engel:** I would not say that we are more focused on our portfolio. I think we are always very focused on our portfolio. You saw us doing a number of what I would call smaller-type transactions in 2015. Our custom synthesis business which we divested comes to mind, our paper hydrous kaolin business and our textile business. I am sure that we have a couple of smaller divestitures done more in 2015.

This year, we had the automotive refinish transaction in China, a smaller transaction, but one that helps us to improve our footprint in automotive refinish significantly. We announced the divestiture of our polyolefin catalyst business to W. R. Grace, which is a transaction that follows the logic of: Yes, we are a polyolefin catalyst producer but we don't produce polyolefins anymore ourselves; we divested that business a long time ago. So technology access there is not what others have. So that's what I would call a logical step we are making there. And then we are divesting our industrial coatings business to Akzo.

Again, I would not say "a higher focus on portfolio" – the same focus that we always have, the same pruning of the portfolio that we always do and that you can expect us to also continue to do going forward.

# 4 Segments

## 4.1 Chemicals

**Andreas Heine (MainFirst Bank):** On Chemicals and the volume here; it was down 3 percent. As you were referring to some customers starting to restock, which obviously would first happen in Chemicals, where you are closer to the oil price, and having in mind that all the start-ups you have done in the second half of last year should also add to the volume, why is volume down here and not up? How is the ramp-up of these large, big plants in this segment going?

**Hans-Ulrich Engel:** The overall minus 3 percent that we have in the Chemicals segment was influenced by some, what I would call, special effects. Number one and on the volume side, actually, the biggest impact comes from running the splitter that we have in Port Arthur; that is the condensate splitter. That feeds naphtha into the cracker or we sell it into the market in Port Arthur. These are huge volumes that run to that machine, which ran in Q1 of last year and didn't run in Q1 of this year, due to the fact that condensate prices, as a result of lower condensate production in the U.S., were not attractive enough to run the big machine there. That had an impact in the order of magnitude on the Chemicals segment of one percentage point, slightly higher than that.

We then have caprolactam sales, which used to go to third parties, which we now consume internally as a result of the start-up of the new polyamide-6 plant in China. That is another impact on our volumes that we are showing here, because what we are showing is volumes to third parties.

Taking out these effects, volume growth in Q1 is flattish. We have one other major impact and that is the big turnaround that we had at the Geismar site. The Geismar site in the U.S. every five years goes through a major turnaround where we are shutting down the entire site. This year, it was down for, I believe, 55 or 60 days. That also has a major impact, then, on volumes.

Your question with respect to the new capacities that we have started up: We grow into these capacities. There are positive contributions to volume development coming from these capacities, as we expected. But overall, as mentioned already on our calls in Q3 and Q4 last year and our earnings call for the full year 2015, we are growing into these capacities – as a result of overall slower growth – more slowly than what we had originally expected.

**Patrick Lambert (Raymond James Euro Equities):** On Chemicals volumes, if I look at U.S. sales, in particular isocyanates, I think compared to your peers your volumes were slightly up in MDI, but clearly below Huntsman and Covestro. Is it also because of internal use versus third party or some delays in ramp-ups of some of your plants?

**Hans-Ulrich Engel:** On the isocyanates, I am not sure where you are getting this information from that our MDI and TDI volumes are developing below what we see at competitors. What is certainly correct is that we have an impact in Q1, as a result of the turnaround that we have in Geismar. As already mentioned, Geismar was down for almost two months. This includes the MDI and TDI capacities that we have in Geismar. Yes, that has an impact. But overall, I think this will even out during the course of the year, because others will also go through their turnaround cycles. As I say, that should then even out.

Other than that, in monomers, we have the impact on volumes that comes from caprolactam which we don't sell to the market anymore, certain quantities of caprolactam which we now consume internally as a result of starting up our polyamide-6 plant in Shanghai.

**John Klein (Berenberg):** I am actually just looking for a quick comment on your view on acrylic acid. We have seen propylene prices rising in April. Can you hike acrylic acid prices? Will those price hikes stick? Or would that just mean a rise in imports?

**Hans-Ulrich Engel:** We have seen acrylic acid prices in cross country for quite some time now. Propylene prices increasing should provide us with the opportunity to increase prices. If I recall correctly, we announced price increases already. Whether or not they will stick, frankly, I do not know yet. This remains to be seen.

## 4.2 Performance Products

**Andrew G. Benson (Citi Investment Research):** Could I perhaps be looking at the competitors and some of your peers? On the Performance Products side, can you give more detail on the performance and the outlook and perhaps a little bit of focus on Care Chemicals, SAP, vitamins and such like, just give us a little bit of help on how you see the outlook?

**Hans-Ulrich Engel:** On Performance Products: Vitamin is always an interesting one, in particular vitamin E – what do we see with respect to vitamin E? We saw new lows during Q1. I think the average published price is, if I can recall that correctly, in the 4.80 range; that's ~4.80 euros per kilogram.

But we also saw a very interesting development towards the end of the quarter and going into the month of April: a significant increase in prices, in particular in China. Apparently, there are a number of shutdowns there, announced as being of a temporary nature. And that has moved vitamin E prices up significantly.

What's going to happen there remains to be seen. It remains to be seen whether the supply will come back or not. Frankly, at this point in time, I don't know.

The superabsorbent business has become more competitive over the last 12 to 18 months; we see this. We see price pressure accordingly, we see margin pressure following that. But I can also tell you that SAP is a good business for BASF. We will launch in relatively short time or sell as commercial product the SAVIVA® product which we already showed you, I think, a year or one and a half years ago in one of our meetings. And we think that will help us to stay in the SAP business where we are or even improve our situation.

## 4.3 Functional Materials & Solutions

**Markus Mayer (Baader Bank):** I have got a question on your chemical processing catalysts and the polyolefin catalysts divesture. What is the effect that your approach creates, basically, that you have sold this asset in an auction process?

With regard to the comment you made on the reason why you sold it: Could we also think that you basically sold part of your fine chemicals business and therefore your fine chemical catalysts might be divesting candidates? Or do you say that now you are happy with your chemical processing catalysts and therefore we should not anymore expect any kind of actions there?

**Hans-Ulrich Engel:** I take your question on the polyolefin catalysts. This was not what I would call a full auction process. This is a highly competitive offer that we got from Grace. If you look around and ask yourself the question, how many potential buyers are out there for a business like that who would be best suited to buy that business, I think we found the perfect buyer for that business.

Regarding your question on fine chemicals catalysts – I think the answer to that is: We are very happy with our chemical catalysts business. For this one year, for the polyolefin catalysts, there is the rationale that I gave you. I don't see that in other parts of the chemical catalysts portfolio.

## 4.4 Agricultural Solutions

**Christian Faitz (Kepler Cheuvreux):** First of all, are there any channel inventories outside of Brazil in agro? Can you please elucidate that a bit? North America and Europe, what's the inventory situation like in agro?

**Hans-Ulrich Engel:** Inventory situation: Relatively high channel inventories, not only in Brazil, as mentioned by you, but also in North America. Europe seems to be a little better but, frankly, based on the recent weather development which resembled more winter-like developments, it remains to be seen what is going to happen in this season. I can tell you that the activity that we have seen over the last ten days in Europe was certainly slower than what you usually would expect at this point in time in the season. So, again, also in North America relatively high channel inventories.

## 4.5 Oil & Gas

**Jeremy Redenius (Sanford C. Bernstein):** Could you talk about the effects of a couple of things in the Oil & Gas earnings throughout the year? First, I am wondering if the Yuzhno Russkoye adjustment had impact on Q1 and how you expect that to play out throughout the year. Secondly, we know that part of your gas sales, at least in Europe, are lagged six to nine months after Western European spot price. I am wondering, with gas prices falling even more in April, does that mean we are going to see considerably lower gas prices locked in for the rest of the year for this business?

**Hans-Ulrich Engel:** The Yuzhno effect is one that we spread evenly over the quarters. So, you will see the same impact there in Q2, Q3 and Q4 as you have seen it in Q1 of this year.

On natural gas, the time lag in fact had a big impact in the past at times when the majority of the contracts were based on oil price formulas – let's say five to six years ago. Over time, more and more of the contracts are market/spot price-based. Yes, there could be an impact in the remaining oil price-based portfolio, but that should be relatively small.

**Jeremy Redenius (Sanford C. Bernstein):** So, when you price natural gas today, it is pretty close to spot price then as opposed to spot price with a lag?

**Hans-Ulrich Engel:** Yes, with the rough majority.

**Patrick Lambert (Raymond James Euro Equities):** Following Jeremey's questions on Oil & Gas – I don't know if you really answered them: The Russkoye adjustment, how should we take that into our model in terms of EBIT? Is it just the volumes of Russia contribution going down, as we put it, or a special event on EBIT per se?

**Hans-Ulrich Engel:** First of all, your Yuzhno Russkoye question, to put things in perspective: As a result of this make-up year that we have, we get about half the volumes out of Yuzhno Russkoye compared to the prior year in 2016. That then also has a significant EBIT impact. This EBIT impact is spread over the four quarters evenly.

**Patrick Lambert (Raymond James Euro Equities):** Would you quantify the Russkoye adjustment in Q1?

**Hans-Ulrich Engel:** I think I cannot because that is covered by the confidentiality agreement that we have with Gazprom – sorry. But – let me help you there – it is significant; it is a lower triple-digit million figure for the full year.