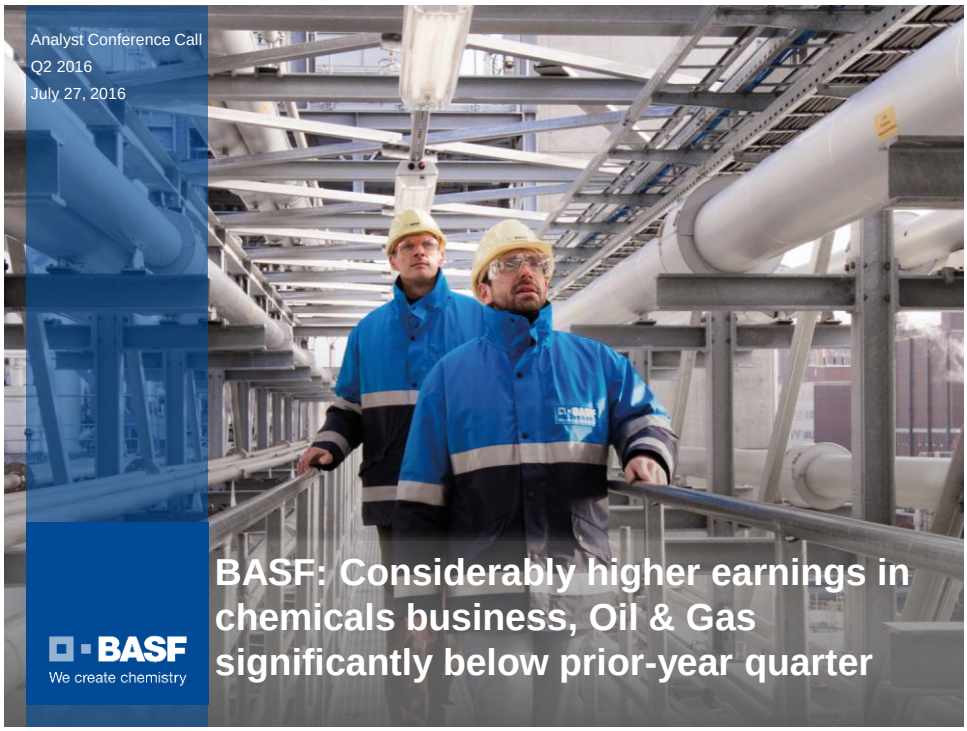
BASF Q2 2016 Analyst Conference Call



Transcript – Q&A Session by Topic
July 27, 2016

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Paul Walsh (Morgan Stanley): The volume growth that you reported in the second quarter, have you seen anything so far in Q3 that would warrant any concern, given the increased volatility out there, automotive, construction, electronics, and if the more cyclical markets are showing a bit more nervousness in the supply chain and, if so, which divisions you are seeing that across?

Kurt Bock: On the question concerning demand going into Q3. Our concern always has been: There is a little bit of restocking and maybe then it's tempering off. So far, we haven't really seen this. So it continues into July. But the caveat is always that July and August are relatively weak months, as we all know. So it's really important how we get out of the summer lull at the end of August, and that's too early to say. But at this point in time, it looks like it is okay.

But I repeat it several times: The heightened uncertainty is due to macroeconomic and political factors, and that is probably too early to judge how these will develop further and what kind of impact they will have.

Paul Walsh (Morgan Stanley): Did you say, Kurt, that you needed the oil price to go up from here to hit your guidance or not? Sorry, I am just not sure if I interpreted that rightly or wrongly.

Kurt Bock: No, that would be an overinterpretation. We have said that we continue to think that the oil price will stay on average at 40. And our guidance is based on these 40 dollars per barrel. If the oil price goes up, that would be warmly welcomed. And even more so if the gas price goes up.

Jeremy Redenius (Sanford C. Bernstein): I just wondered if you could elaborate a little bit more on your comments about China's contribution to the business in the first half of the year versus the second half. In your Report you talk about growing faster than you expected or at least slowing less than you expected, with the automotive industry benefiting from some stimulus, as well as the housing market.

Could you talk about how much that helped you in the first half? Does that persist into the second half in your view?

Kurt Bock: We had a relatively good development in Asia in the first half and Q2 as well. Actually, local EBIT is already at the level of last year's entire year, which is not a bad development. There are a couple of reasons: We have pushed more volume. I think this is possible and necessary – possible also because we have capacity now available, a couple of start-ups, particularly in China. They get traction now. We have worked also very, very diligently on our cost base. So this is a combination of factors which helped to improve earnings considerably.

China continues to grow – however, a little bit more slowly than what we had previously expected. For our businesses, automotive, we see a good and healthy development overall. And this is obviously not just a question of market development, but also a question of market share development. In those businesses, I think, BASF is quite competitive and we are quite optimistic about pushing and moving these downstream businesses further ahead.

We continue to have in some of the upstream markets unsatisfactory margins, obviously, in China, being it acrylic acid or the isocyanates. And this will take some time – and not just one year – to be resolved.

Jeremy Redenius (Sanford C. Bernstein): I was also trying to ask: Was the first half result boosted to some degree by stimulus measures that you might expect to fall off in the second half of the year?

Kurt Bock: I cannot say yes, I cannot say no. It's very difficult for us to make a judgement call here. We are not aware that we have benefited in any particular way from specific incentive programs. There have been incentives for the automotive industry, obviously. I don't think it has had a material effect.

Andrew G. Benson (Citi Investment Research): Just a couple of points on the tax rate because it was a bit volatile in the first quarter and second quarter. Can you provide some guidance there?

Hans-Ulrich Engel: Andrew, on the tax rate: I think, with respect to Q2, your comment is not really correct because the tax rate in Q2 is almost exactly where it was in last year's Q2: 26.9 versus 26.8. But you are absolutely right if you look at the developments that we had between Q1 and Q2 as well as on a half-year basis. That volatility that you were addressing there is driven by the Oil & Gas business and there, in particular, by our Norwegian activities where we had last year a situation where gains were taxed at 78%. This year, as a result of the extremely low oil prices, there are no gains to be taxed. In fact, in Q1 we had a situation where there was actually a tax gain in our Oil & Gas business. So, factoring all of that together, I understand that it is difficult to see the full development and the full picture, but these are the underlying developments that we have in the Oil & Gas business.

Andrew G. Benson (Citi Investment Research): You talked about one-off costs in terms of higher shut-down and start-up costs. Can you just try and quantify those for us in the second quarter and the sort of run rate for the full year?

Hans-Ulrich Engel: Shut-down and start-up cost: Please understand that I don't provide you with the exact figures. Costs for turnarounds in Q2 of this year are higher than in Q2 of last year. We had a turnaround in Ludwigshafen, steamcracker II and then downstream plants as well as the ammonia plant in Antwerp.

Peter Clark (SG Corporate and Investment Banking): I have a quick question on capex. It is down 30% in the first half. Obviously, you had guidance for the year. But I am just wondering if that could actually dip towards 4 billion or below this year.

Kurt Bock: Capex: The run rate is currently slightly below of what you would expect for half of the year. 50% of the time is already behind us. But we also know that December and November are quite busy months for capex spending. The goal is to reduce spending overall by about 1 billion. I think we are on track to achieve that.

Andreas Heine (MainFirst Bank): My first question is basically on the balance sheet, seeing now that the financial debt are 14 billion euros, pension provisions are almost 10 billion euros, Chemetall comes on top at the end of this year. That is quite a debt load and quite unusual for BASF. Could you put in context what your firepower for potential external growth is and whether you still look for external growth and how important the A rating for BASF is?

Hans-Ulrich Engel: On debt load. Actually, if you look at our net debt end of Q2 2016 and compare it to net debt that we had at the end of Q2 2015, we are 1 billion euros lower. We were at 15.1 billion euros net debt end of Q2 last year and are right now at 14.1 billion euros.

Our A rating is important to us. Based on the guidance that both Moody's and Standard & Poors gave after we announced the Chemetall transaction, they did not feel compelled to change our rating.

Pensions: Yes, we have seen an increase there, roughly 3.5 billion euros compared to the end of 2015. But that is basically also the same situation that we were in at the end of Q1 2015 where we also had pension obligations of 9.6 billion euros and – you followed what happened with interest rates during Q2 of this year – we saw a drop of interest rates in the main geographies where pensions are relevant for us, which is Germany, the UK, Switzerland and the United States, to the tune of 100 basis points. So we are pretty much in the same territory with respect to interest rates that we were in at the end of Q1 2016.

Patrick Lambert (Raymond James Euro Equities): A very broad question, but short-term, regarding Brexit: Have you had the occasion to discuss especially with the OEMs the automotive markets, the short-term trends in terms of production, exports to the UK and a potential impact on your overall exposure to automotive in the second half? Is there any increased volatility in terms of order patterns or projections that you have to do in automotive exposure?

Kurt Bock: We have no information at this point in time, actually. We follow the same news flow, obviously, as you do. The automotive industry has a certain role and the value chains connecting the UK and the continent are very, very important, but at this point in time I am not aware of any possible changes.

From our point of view: We have production all over Europe. As long as the cars are being produced, regardless of where, we should participate as BASF.

Patrick Lambert (Raymond James Euro Equities): But at the moment you haven't seen any cancellation of orders or different patterns of orders?

Kurt Bock: No, we haven't.

Martin J. Evans (JP Morgan Cazenove): It's this time of year when the chemical industry often focuses on August and potential customer plant shutdowns, particularly in auto, obviously. Have you had any indication so far as to whether this year will be sort of any better or worse than last year, following your customers? I am assuming, given that in some areas the volume situation is a little bit better, you'd anticipate the shutdowns won't be any longer than last year.

Kurt Bock: As I said before, July so far is where we expected it to be. There is this typical summer lull, very much driven by the automotive industry, obviously. But we haven't seen anything special here. We still believe that the automotive industry this year will grow globally by something like 3%, 2.9%. So, from our point of view, this is still moving in a right direction.

Lutz Grueten (Commerzbank): My question is on volumes. China has announced that around the G20 Summit there will be shutdowns in the region for, I think, two weeks or so. Is there anything we should expect on the third quarter regarding lower volumes with respect to these things?

Kurt Bock: External factors, G20: Actually, I am not aware of any upcoming production shutdowns for us in China. I don't think this has any material impact. This hasn't been raised by anybody of our folks in Asia and in China in particular.

Andrew G. Stott (UBS): My question is actually just around costs. You have mentioned fixed costs flat despite the start-up costs of 200 million euros. Actually very impressive was the detail of that: selling expenses down 7 and general down 10 and R&D, which is very unusual for BASF, down double digit year-on-year.

So I guess my question is fairly simple: Are we getting to a level now where you have sort of done what you can before you start to maybe move into some of the muscle?

Kurt Bock: I may say: Good question. But I don't think we have come to a point where cost management reaches a limit. The numbers – please keep that in mind – also include a little bit of a currency effect that needs to be taken out. But nevertheless, cost have come down and will continue to do so. I don't think there is any reason to be less aggressive going forward.

Andrew G. Stott (UBS): Can I just follow up on that? Specifically on R&D, it's unusual to see it down that much. Obviously, you have got a commitment to grow R&D in line with sales to keep the ratio constant. Should I expect that to flip back up?

Kurt Bock: We don't think that R&D is going to grow in 2016. At the end of the day, again, it depends on currency exchange rates. We have a couple of programs in place to take cost out and we also have some structural changes. One is e.g. the lower spending on plant biotech, which is a U.S. operation by and large. So there is a little bit of a structural effect, but going forward R&D cost probably stay where they are in nominal terms.

Laurent Favre (Bank of America Merrill Lynch): My questions are related to the Chemetall acquisition. The first question: I was wondering if you could flash out why you see the strongest growth opportunity beyond the underlying market growth in autos. Do you think this is a market that can actually outgrow the autos industry?

The second question is on the synergy that you see from that deal. Basically, I am wondering what kind of synergy you'd expect so that the return on capital on the deal approaches cost of capital for BASF.

Kurt Bock: Chemetall: As I said in my little speech, we believe this is a strategically very nicely fitting acquisition for BASF. It didn't come cheap. So we have to manage it very, very successfully, obviously, to create value for our shareholders. It's a very well-run company and operation. We see certainly opportunities to grow the business above and beyond of what we have seen so far, especially because we can combine the surface treatment technology with our coatings technology. This is quite an important trend in the automotive industry: at the end of the day, how to take out additional layers of the coating process. There, the surface treatment also plays an important role.

Please keep in mind that this is not just about auto. Auto is important, but Chemetall is active in many, sometimes relatively small but also very important and very attractive markets like the aircraft construction industry, where they are very important for treating the blades for the turbines of aircrafts. This is really high-tech and an interesting and fascinating technology.

Synergies: We have said they are industry-typical. You can rest assured that BASF goes through each and every potential synergy. But we haven't even yet closed the deal; we just signed it and published it. So I think that it is also fair to wait for the process to start together with the new colleagues which will join us hopefully as soon as possible, as soon as the authorities have approved the deal.

Laurent Favre (Bank of America Merrill Lynch): Can I ask you if something has changed from your perspective in this business since the time it was for sale a few years back? Is it just that you didn't quite like the package of Chemetall plus lithium? Or has something changed within the Chemetall business?

Kurt Bock: As I said, it's a well-run company, but I am not aware that it ever has been offered separately. Now it was offered separately. And that gave us the opportunity to go after it.

Stefanie Wettberg: With regard to our reporting, I would like to inform you that the German legal requirements for financial reporting in Q1 and Q3 have been eased. From October 2016 onwards, we will publish quarterly statements for the 1st and the 3rd quarter based on this new legislation. These statements will be more condensed but will, of course, continue to provide you with the relevant financial information.

The formats of the half-year and full-year financial reporting will remain unchanged and our analyst conference call will also take place as usual.

2 Segments

2.1 Chemicals

James Knight (Exane BNP Paribas): In Chemicals, did you have any influence in the second quarter from the condensate splitter in North America? You mentioned that in the first quarter as a headwind on volumes. I guess, if there was a negative influence, given you reported pretty good volumes in the second quarter, do you think any of that was driven by restocking?

Hans-Ulrich Engel: James, first on your condensate splitter question: We had a similar situation as in Q1 2016. Due to the price of condensate in the U.S. and the way we run the cracker in Port Arthur, the condensate splitter did hardly run – or in other words: did not really run.

The second thing that you may want to keep in mind when you look at the Q2 results in Chemicals is that we had turnarounds both in Ludwigshafen and in Antwerp. It's the steamcracker II and then the downstream plants that we had down for the usual turnarounds, plus then the ammonia plant at BASF Antwerp. Overall, I would describe the demand situation in our Chemicals segment as pretty healthy.

Peter Spengler (DZ Bank): I have a question on your new TDI plant in Ludwigshafen: What's the current status of this plant? Maybe you can elaborate on how you ramp up in the second half. What is the current status of your second plant in Schwarzheide which you want to close down?

Kurt Bock: Both plants are obviously related: As soon as we ramped up Ludwigshafen – what we plan to do as quickly as possible, we go into the shutdown mode in Schwarzheide. This is an ongoing process. That's what I can say at this point in time. It should happen any day.

And then the real question is: How fast can you ramp up? You are aware: We have the 80,000 tons available in Schwarzheide, which we then will discontinue. Currently, we have exports from Asia into Europe for TDI. Those trade flows also then would change as soon as we have full capacity availability here in Europe.

Markus Mayer (Baader Bank): I have one add-on question to this TDI ramp-up. Can you update us on the ramp-up cost? Was there any change there?

Kurt Bock: TDI start-up cost: I think in the Q1 call Hans said something like 200 million of start-up cost in Chemicals. That encompasses everything, obviously, some other start-ups as well. That number is still valid from today's point of view.

Lutz Grueten (Commerzbank): On MDI: The joint venture you have got with Huntsman and local partners in China to double the capacity to 480,000 tons, is it still on budget, is it still on time? I think you have got all the permissions, but it would be great to get an update on the timing here.

Kurt Bock: We are working on this project. But since this is a joint venture operation – it has quite a few partners, as you are aware – I would refrain from making a comment here from our point of view.

2.2 Performance Products

Anthony G. Jones (Redburn): I just want to understand the drivers behind the margin improvements in Performance Products a bit better. It looks like cost savings are taking effect, but also volumes are up a bit and there must be some raw material gain in there. On that point, it looks like the EBIT margin was sequentially lower in Q2 than Q1. So, to have a better understanding of what's going on, could you perhaps weight each of those contributions in terms of how important they are? And how should we think about them as we move into the second half of the year?

Kurt Bock: There are a couple of factors and you mentioned them all: There is volume growth. That was certainly helpful. Overall, we have an improvement in earnings of roughly 200 million. I'd say, approximately half of that is margin. A quarter comes from volume and a quarter comes from cost containment measures.

Anthony G. Jones (Redburn): Do you have any thoughts on what could reoccur in the second half of the year? How much of the raw material will still be there or will that fall away?

Kurt Bock: It's hard to say. It also depends on the raw material cost development or price development. What you normally can expect is that some contracts are renewed and then customers in some cases might look for a lower pricing. But that's too early to say. Our goal is obviously to continue the journey which we have had in Q1 and Q2. And we will certainly also continue with our cost improvement measures which are under full swing.

Peter Clark (SG Corporate and Investment Banking): A follow-up to Tony's question. I didn't quite catch the split of how the margin was made up in the Performance Products, but I think I caught the raw materials could have been about a quarter or so, below variable cost.

I am just wondering, assuming volumes were okay, you must be pretty confident then that all the work you have done there has produced a structural step-up in the margin here. So you are pretty confident about a decent margin rate moving forward.

Kurt Bock: With regard to Performance Products, what you describe is certainly our objective to have a structural earnings leap. We are working extremely hard, the entire team, to achieve this. We had a little bit – I mentioned this – of tailwind from the margin development. That should never be taken for granted. So the idea is to continuously improve the business further on. So far, it worked quite nicely in Q1 and Q2.

Paul Walsh (Morgan Stanley): Around vitamin pricing in particular: Obviously, Performance Products had a great performance in the second quarter. Vitamin pricing is up, both A and E. Could you help me understand how sustainable you think that is and the factors that are allowing you to secure those price increases, where over recent years they have more or less failed to gain traction?

Hans-Ulrich Engel: Vitamin A and E prices are up. Certainly, I would say, that's good news. Being cautious, my answer to your question is: How sustainable that is remains to be seen. We have seen price improvements in particular in vitamin E where we were below 5 euros per kilogram at the beginning of the year. There were first rumors about Chinese competitors shutting their activities either in or down.

It's pretty clear that something happened there, but what this means and whether these capacities will come back to the market, frankly, we don't know at this point in time. But the price developments in A and E are certainly welcome after many years where we have seen nothing but declines. In the first half of this year, the trend is up and we hope that this will continue.

Markus Mayer (Baader Bank): On your hygiene business and Care Chemicals: For how long do you expect this very competitive environment to last?

Kurt Bock: Let me start with hygiene. That will stay competitive for quite some time because there is added capacity, essentially for superabsorbants. They will weight on the market for quite some time. As you know, some of the products have been commoditized over time. For BASF, the solution has been innovation and we have launched a new product. Actually, we introduced it to the market. Currently, we are building the plant in Antwerp. It is a technology which is called SAVIVA®. If I remember correctly, we even introduced it at our Full-Year Results presentation last year. There you can clearly see that there is quite a big benefit for consumers and therefore also for the producers of baby diapers. We are currently pushing this into the markets.

Mutlu Gundogan (ABN AMRO Bank): I have a specific question on your JV with Petronas Chemicals. I was wondering if you can update us on the progress on the integrated aroma ingredients plant in Malaysia, whether that's still on track. Because of the, I would say, soaring vitamin prices, is it possible to produce vitamins on that site?

Kurt Bock: The project is on time, on budget, ready to start up in the second half. The teams are working very, very hard now to make this happen. We are quite satisfied with that development in Kuantan, yes.

Mutlu Gundogan (ABN AMRO Bank): And is it possible to produce vitamins on that site, or is it for the consumer chemicals?

Kurt Bock: It's what we call the citral value chain. Based on citral you could produce all kinds of pretty sophisticated chemicals, including vitamins. However, this complex in Asia is really directed at aroma chemicals.

Martin Rödiger (Kepler Cheuvreux): In your quarterly report, you mentioned that the volumes in human nutrition went down in the second quarter. Can you tell us about the background why demand was so poor for human nutrition?

Kurt Bock: There were some timing effects and pre-buying effects in 2015 in the nutritional supplements business, which make it a tough comparison. This year, we also had the five-year turnaround in Ludwigshafen in the citral plant which was down for quite some time.

2.3 Functional Materials & Solutions

Laurence Alexander (Jefferies): Could you flash out a little bit the volumes that you are seeing in Construction Chemicals and automotive catalysts? Are either of those seeing disproportionate share gains?

Hans-Ulrich Engel: Let me start with your question on automotive: We have seen overall Q1 and Q2 a pretty healthy development in line with our expectation, global growth in production roughly 3%, also distributed in the way that we thought it would be. There has been a very healthy development in North America, a little bit slower in Q2 than in Q1, but still healthy. It's very weak in South America. There has been a good, strong development in China, also positive development in Western Europe. Russia and South America are weak and actually with even lower volumes than what we experienced there last year.

With regard to share gain – I assume you are referring to our business – it's always difficult to say whether we are winning or losing share. But if you look at our automotive business overall and how it has performed over the years, you see it with volume increases in excess of global car production. That gives you at least a very good indication of what is happening with our business.

On construction: A good, positive development, in particular in North America, also a solid development in Europe. There again, I have to say, confirming what we already said in the first quarter, there is construction going on again in the southern part of Europe, which we see as quite positive.

In Asia we have experienced, and there in particular in China, that after the increase in construction activity in Q1, which may have been driven by stimulus measures, we have seen a certain decline in Q2.

Kurt Bock: And obviously, Laurence, construction is a very local, very regional market. I give you just one example: In Saudi Arabia, financing is very, very tight and it's an important market for BASF. We have seen a considerable decrease in that market – just to give you a little bit of flavor here.

Andreas Heine (MainFirst Bank): On Functional Materials & Solutions: That was a sector where I was surprised on the strong performance in the second quarter. That was already on EBIT the case. But the D&A was unusually high, so that EBITDA was even better. So maybe you can explain a little bit how we have to model the D&A going forward and how you see this in the second half. Is there something really special in the second quarter or is it really that good also going forward?

Hans-Ulrich Engel: On your question with respect to Functional Materials & Solutions: Yes, there is a bit of an uptick in our depreciation and amortization. Please keep in mind there that we have a number of new plants. That's contributing to that. In addition, we had a smaller double-digit impairment in one of the businesses in Functional Materials & Solutions. That is the explanation for the higher depreciation and amortization that we had in Q2.

2.4 Agricultural Solutions

Andrew G. Benson (Citi Investment Research): You mentioned on a call earlier about Ag not being for sale. Does that include any sort of potential joint ventures? I guess, on the other side, presumably you would be interested in bolt-on acquisitions at least in that area.

Kurt Bock: On Ag: Even if I sound like a broken record, we have a good business, a good, performing business. There are always fluctuations and we have seen this now in Q2. But underlying growth and earnings capabilities are very, very good. We have an excellent pipeline. We have some good products coming to the market very soon. We are very, very optimistic that this really will propel additional growth for BASF. Having said that, nevertheless, we are certainly looking for bolt-on acquisitions if possible, if businesses will be offered to the market. That needs to be seen. Due to this ongoing consolidation, there might be some opportunities and then we take a look as, I am certain, some other companies will do as well. Other than that I cannot really comment. I have said that the business is not for sale. Again, this sounds like a broken record. But it has been true and stays true.

Martin Rödiger (Kepler Cheuvreux): On the outlook for the segments: We hear you say on Reuters that Ag Solutions is somewhat weaker this year than previously expected. Could EBIT in this segment also drop this year, as it was down by 3 percent in the first half? I know that the first half is much more important than the second half. Do you stick to your previously given outlook for the Ag Solutions segment that the EBIT will slightly increase this year?

Kurt Bock: Volumes were relatively weak in the first half of 2016. We see some channel inventory going into the third quarter. Europe, actually, was a little bit disappointing, mostly weather-related. This could lead to the conclusion that it might become a little bit more difficult than previously anticipated to achieve this slight increase. So we cannot rule out that maybe earnings in Ag come in slightly below last year's numbers, but that is really too early to say. The entire team is working very, very hard to make the numbers. When you look at the cost structure, you can also see that the self-help measures which we have implemented get traction. So we are working extremely hard, but you cannot rule it out completely. The forecast today is certainly more ambitious than six months ago.

Laurence Alexander (Jefferies): Can you give a little bit more detail on agricultural inventory levels and whether you think that can be worked down over the next season or whether it might take a couple of seasons to get worked through?

Kurt Bock: Ag: We see different developments region-by-region. For us, as I said before, Europe was relatively slow. We believe there are relatively high channel inventories, at least for fungicides, in Europe. That makes us a little bit cautious for Q3. South America: We don't see any imminent recovery. The farmers are in a relatively weak position and we have to be very, very careful also to manage our financial exposure, which we do quite smartly. And, again, relatively high channel inventories. North America: overall, from our point of view, okay. Asia: good development for BASF this year. But, as you know, Asia for us is a relatively small market because we don't have an extremely broad portfolio in insecticides, which play a bigger role in the Asian markets.

2.5 Oil & Gas

Patrick Lambert (Raymond James Euro Equities): On Oil & Gas: If I strip the gas distribution contribution, were you EBIT-positive on the production and exploration?

Hans-Ulrich Engel: Were we positive in Q2 in the exploration and production business? – Yes, we were.

Lutz Grueten (Commerzbank): On the oil price sensitivity which is quite helpful to get in the Factbook. Is there also any chance to get a sensitivity regarding the gas price?

Hans-Ulrich Engel: Frankly, if we could provide you with something that is reliable, we would do so. But when you look at our gas portfolio, you see that we have regulated prices, we have non-regulated prices, we have Russian domestic prices, Russian export prices, we have Argentinian prices regulated, then Argentinian prices under a new gas price system, we have market prices for production in North Western Europe. Frankly, there is so much noise in that system that we don't feel comfortable with providing a clear guidance there with respect to gas price sensitivity.