

BASF Q3 2016 Analyst Conference Call



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

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1 Statement on the fire at North Harbor in Ludwigshafen

Dr. Kurt Bock: Let me briefly describe the course of events and the consequences. Due to the fire at the North Harbor and the interruption in raw material supply, both steam crackers and more than 20 further plants were idled on October 17. The fire damaged various pipelines including those for the delivery of raw materials, such as naphtha, propylene and ethylene.

The North Harbor is not operational until further notice. Therefore, we are temporarily shifting logistics from ship and pipelines to trucks and trains, wherever possible.

Production plants at BASF's Verbund site in Ludwigshafen were not damaged by the fire. The riverside harbor, the harbor on Friesenheim Island and the tank farms are all operational.

As of today, eight plants are still temporarily shut down, others run at reduced utilization rates. We have delivery delays, mainly with respect to propylene and ethylene-based products. Various measures are being taken to minimize the impact on customer deliveries.

Our main focus is now on normalizing operations. The larger steam cracker has been started up successfully. Preparations for the start-up of the smaller steam cracker are ongoing. We will gradually and as quickly as possible restart or increase production at most of the affected plants. This will improve product availability.

Let me also share the preliminary findings published yesterday by the District Attorney of Frankenthal/Palatinate and the regional police headquarters. According to their news release, "there was a cut made in a pipeline. This was apparently done with a cutting disk. Maintenance work using an angle grinder was in progress on an adjacent pipeline. The cut pipeline was not part of that work. This pipeline contained flammable raffinate. Investigation teams and experts are now concentrating on the process of the maintenance work and the safety measures taken before maintenance started. The clarification of the connection between the cut and the explosion requires further extensive investigations."

As investigations by the relevant authorities are ongoing, please understand that I will not further comment on the cause of the fire at this time. We will inform you as soon as possible about any additional findings and the respective conclusions.

Furthermore, please understand that we cannot provide you with a detailed assessment of the financial impact at this point in time. So far, we have made good progress to bring our production back to more normal levels. Yet, we are facing a number of uncertainties. As the facts become more clear over the next days and weeks, we will be in a better position to provide you with information on the financial impact. We have, obviously, adequate insurance coverage for property damage, business interruption and liability.

Concluding this section, I would also like to thank those of you who sent us e-mails and called us to show their support. We were very grateful that you expressed your sympathy during this difficult time.

2 BASF Group

Neil C. Tyler (Redburn): The question that I'll ask is on the sentence in your outlook statement that refers to the lower level of tied-down operating capital and therefore the change in your expectation EBIT post cost of capital. Firstly, is that lower level of operating capital due to the lower production as a consequence from the incident in Ludwigshafen? Secondly, how does that change in the EBIT after cost of capital influence thinking around the dividend? Or can you perhaps elaborate a little bit on the link between that and the dividend?

Kurt Bock: You know that it is a key metric for us: earnings after cost of capital. Last year's number was certainly not at a sufficient level. We are now slightly more optimistic that we will come in well above last year's number, due to – essentially – reduced capital employed. This is no effect of the recent situation in Ludwigshafen; it is completely independent from that. This metric is not really related to dividends. This is for us a health check, the earnings after cost of capital, because it really demonstrates whether we create value from a shareholder's point of view. We have a clear dividend policy, as you know, to increase dividends year over year, unless something very dramatic has happened.

Neil C. Tyler (Redburn): Would you mind helping me understand the lower level of tied-down capital in that case. If you just look in the balance sheet, there does not seem to be a great deal of movement in the assets and liabilities relative to last year.

Hans-Ulrich Engel: What you have to keep in mind here, Neil, is that this was part of the guidance. Actually, when we gave the guidance earlier this year and did our cost of capital calculation, we had done the calculation with overall higher raw material cost. So, our expectation was that actually the value, the net working capital value on the balance sheet would be higher than what we are currently experiencing. The other thing that we need to keep in mind is: At an EBIT after cost of capital of, if I recall it correctly, €194 million in the year 2015, it doesn't need an awful lot of change to get to 10 percent more, which then is considerably more in our definition.

Lutz Grueten (Commerzbank): You stated that volumes in Asia have been up considerably in the third quarter. One of your competitors stated that volumes in China, in fact, have been up 25 percent in the third quarter. So it would be great to get any better grip on actual numbers here, at least for Asia, double-digit or some quantitative statements here.

Kurt Bock: Volumes in Asia: about 15 percent up and China above 20 percent. That is what we have seen. As we all know, Q3 is not the strongest quarter, so we have to see if this continues at the same pace. But from today's point of view, we are quite optimistic that we have made some inroads in some markets.

Paul Walsh (Morgan Stanley): My question is about China. It has been pretty spectacular for everybody in the third quarter. I think a lot of that is the year-on-year comparison being soft. Can you give some insights into what you think is going on there to drive that volume growth? The sort of unchanged language around the guidance, it insinuates at least that maybe you sniff that there are some temporary aspects to that. I wondered if you were seeing anything in China right now that undermined the strength that we were seeing in Q3 into Q4.

Kurt Bock: I think it is very difficult to read the Chinese market. We have seen good automotive demand, which is a very important industry for BASF. But, as I said before, please keep in mind: We also have new capacity installed in China, which is now coming to the market. That is very important from our point of view. So, it was overdue to sell those volumes. It is not just market growth, it is also: We are fighting for our market share at attractive margins.

Paul Walsh (Morgan Stanley): Is that MDI specifically, the Chongqing facility, that you were referring to on the new capacities?

Kurt Bock: It includes Chongqing and it includes polyamide in Shanghai, it includes also automotive-related capacities, catalysts, coatings. We have brought up quite a few new plants – PTHF based on butanediol. So we have lots of new capacity available. That was always our discussion: When do we see the volume growth? – It is coming now.

Paul Walsh (Morgan Stanley): And anything that would undermine confidence in China moving into the fourth quarter? In my mind, the comps are still very weak in China in the fourth quarter.

Kurt Bock: I can only talk about what we have seen in October. So far, we haven't seen anything which changes the picture from what we have experienced in Q3.

Lutz Grueten (Commerzbank): On the cost savings you have achieved in the third quarter year-on-year: It also would be good if we get a number here on that one.

Hans-Ulrich Engel: On cost savings, I just give you a general idea there. As you know, last year at this time, we announced our new program Drive for the entire BASF Group. Target there: one billion euros EBIT contribution in the year 2018. For the year 2016, we are forecasting 300 million euros. I don't have the exact figure of what has been achieved there in Q3.

You also know that we have a major program also in Performance Products. That will fully deliver in the year 2017. Total target there is €500 million. In the year 2016, we will see an incremental EBIT effect there of at least €100 million.

Andrew G. Benson (Citi Investment Research): The fourth quarter of last year was impacted by relatively weak markets and destocking associated with a lower oil price. Can you give some sense of your vision of the fourth quarter now in terms of the benefits if that reverses, if there is some sort of restocking, what the group volume growth can be, and some sort of indication of your ability to meet that, given, obviously, the difficulties in Ludwigshafen at the moment?

Kurt Bock: Q4 2015, you are right, wasn't really a strong quarter. It was actually a pretty weak quarter for us and there was some destocking apparently. So we compare against a relatively low base.

As you know, we don't provide guidance for individual quarters. We really only provide guidance for the entire year. For the time being, we stick to what we have said: EBIT before special items slightly below last year. Slightly below means: up to 10 percent minus.

It needs to be seen where and how we are coming in. There is certainly – I think I alluded to this in my little speech – increased uncertainty now due to the partial production reductions here in Ludwigshafen.

On restocking, we don't really have any indication that this is happening. Europe in terms of growth has been relatively slow, the same for North America. We see – and we mentioned this – good demand overall for our products in Asia, which, I think, has been overdue. With the new capacities now being available in Asia, we simply had to bring up volumes growth. I think it is almost a natural development what we are seeing here.

Andrew G. Benson (Citi Investment Research): You had some associated write-downs. I just want to quiz on the financing line and just understand the breakdown of that and how we should think about total financing costs in 2017.

Hans-Ulrich Engel: Your question on the financial result: Yes, we had a write-down in the order of magnitude of 40 million euros. I believe the correct number is 39 million euros. That affects the financial result. What is that? You may recall that earlier in the year we announced a restructuring of our biotechnology activities. That is exactly a write-down that takes place in a non-consolidated company and then shows up in our financial result.

We also have a slight decline in our interest result, which has to do with, overall, on the one hand side lower interest rates, but a bit higher financing, in particular higher financing outside of Europe and, to be more specific, in Brazil. That comes with higher interest expense. Last but not least, as a result of overall lower start-ups that we have in 2016 compared to 2015, we have also lower capitalized interests. In total, it's more interest than in prior years in our interest line. That explains what is happening in the financial result.

Andrew G. Benson (Citi Investment Research): That sort of level should continue to 2017? Is that reasonable, roughly speaking?

Hans-Ulrich Engel: But for the write-down that you saw.

Andreas Heine (MainFirst Bank): If you look at when the oil price came down, how long did it take until you have seen the relief in your downstream activities? How do you think will this develop if the oil price goes up next year further on?

Hans-Ulrich Engel: Oil price: How it works itself through the system always depends on the type of pricing formulas that we have, upstream obviously much more closely tied to the oil price. What we typically experience is that we have, I'd say, upstream a 30 to 45 days delay in our pricing mechanisms, which we have to pass on oil derivative prices.

That should in theory be similar on the way down as it is on the way up, but obviously, this always depends on the current market environment: What is the supply/demand situation? How does that look like? That can give you more or less pricing power. You can hold on to certain raw material price advantages for longer or for less long. It remains to be seen. But as a general rule, there is always a bit of a time lag.

Markus Mayer (Baader Bank/Helvea): Can you remind us on the interest and inflation rates you are currently using for your pensions?

Hans-Ulrich Engel: On the interest rates for pension purposes: They came down. The main areas for us are Germany, the US, the UK and Switzerland. The interest rates for Germany I remember by heart: At the end of 2015 they were at 2.5 percent and for the end of Q3 we used 1.3 percent. For the US, end of 2015: 4.2 percent, dropping to 3.3 percent by the end of Q3 2016. UK and Switzerland also dropped, if I recall that correctly, in the range of 60 to 140 basis points.

3 Segments

3.1 Chemicals

James Knight (Exane BNP Paribas): Regarding your TDI plant: Could you give us some kind of feel and, preferably, some numbers, but at least some qualitative feel about the ramp-up of your new plant and where we are in terms of the timing or thinking about closing the older plant in Schwarzheide?

Kurt Bock: TDI utilization rates are going up here in Ludwigshafen. We are not yet at full capacity; this will happen over the next couple of months, as we are phasing product into the market. The market is relatively benign, given lack of capacity in some cases, apparently, and margins have developed actually quite nicely in TDI.

James Knight (Exane BNP Paribas): Just quickly a follow-up on TDI: Is there a chance or a rationale in running the Schwarzheide plant for longer, given the current tightness in the market?

Kurt Bock: This is a very operational decision, obviously, at what point in time it is best to shut it down. We have delayed this, as you know. But I don't foresee that this production will continue indefinitely. It will be shut down eventually, as soon as we have reached full capacity here in Ludwigshafen. This is an ongoing process.

Andreas Heine (MainFirst Bank): My question is on the MDI plant in Chongqing. How long will it take to fix the supply issues?

Kurt Bock: Chongqing: As you alluded to, we are not running at full capacity, simply due to raw material supply constraints. We have temporary solutions which allow us to produce at a level which is profitable – let me put it that way. Yet we are also looking for more structural and more permanent solutions and this is under way as we speak.

Andreas Heine (MainFirst Bank): Does that take a year or half a year or only some months?

Kurt Bock: The structural adjustment will take a little bit more time, simply because it will also include an investment.

James Knight (Exane BNP Paribas): On the polyamide chain: We have had a few capacity closures announced, including your own. We are hearing some more positive noises both in caprolactam and PA-6 as well. Where, do you think, are we in that cycle? Is there a realistic chance we see a significant pick-up over the next three, six, twelve months?

Kurt Bock: Polyamide value chain, caprolactam: Obviously, there are overcapacities in Europe. We try to address this by reducing our capacity by about 20 percent from 500,000 tons to 400,000 tons. It needs to be seen what kind of effect this will have on the overall supply and demand balance. I can only assure that we do whatever we deem necessary from our point of view. It is a little bit difficult to speculate on margin developments right now. We have seen a low in Asia, e.g., earlier this year, in Q1. In Q2, margins have gone up again. Margins have been relatively stable in Europe, but still unsatisfactory. So you have to be very, very precise talking about this. Obviously, the huge overcapacities in Asia had a detrimental effect on margins overall for caprolactam. As you know, we traditionally had exported some of our European production to Asia. So we are addressing this with the capacity reduction.

3.2 Performance Products

Martin Rödiger (Kepler Cheuvreux): Can you provide us with an update on the situation in vitamins? Do you see that your Chinese competitors are back on the market after the G20 Summit and thus fully operational?

Hans-Ulrich Engel: On the vitamins, we have seen significant price increases, in particular in vitamin E, spot prices increasing up to a level of 8.30, 8.50 €/kg. We have seen some of the capacities or volumes, Chinese volumes, back in the market and, as a result of that, in October starting a decrease of prices. The decrease of prices at this point in time is 7.50, 7.60 €/kg on a spot level. It remains to be seen how this develops going forward. But it was certainly very good to experience how prices moved back after reaching levels which were below 5 euros per kilogram.

Peter A. Clark (SG Corporate and Investment Banking): My question is a very quick one on Performance Products. For the second quarter, you gave us the line that the raw materials were about half the benefit you were seeing year-on-year. I just want to check: That's obviously still the case in Q3. Within the quarter, how big was the vitamin impact year-on-year in terms of pricing? I think the EBIT increase was 140 odd million euros year-on-year. Just to give a flavour for that, if you would.

Kurt Bock: Just to give you a flavour: Margin improvement, the majority comes from fixed cost management. It is not really overall raw material cost. It is really fixed cost improvement which Hans also explained earlier on.

Patrick Lambert (Raymond James Euro Equities): I think Peter asked on the vitamin EBIT impact. If you could quantify that a bit in the Performance Products division.

Kurt Bock: Vitamins had a positive impact in Q3, but even for that operating division, which is Health & Nutrition, the majority – to make it very clear – of improvement comes from fixed cost management. In the larger scheme of things, it has had a relatively minor impact for BASF.

Laurence Alexander (Jefferies): Can you give some detail about the PVP capacity addition? Is that purely for the domestic market? Do you see the demand available to absorb it or will it be a multi-year ramp?

Kurt Bock: PVP: I think it would be best if you just call us later on and we can give you some more details if you want.

[In 2015, BASF announced plans for global investments into its NVP (N-vinylpyrrolidone)/PVP value chain of up to USD 70 million. The plans include the extension of capacities in Ludwigshafen and Geismar, along with technology introduction in Shanghai, China. PVP is a thriving global market with perpetual growth driven by Asia. BASF is expanding its global production network of PVP to obtain the highest levels of supply reliability and security for our customers globally and more significantly in Asia across several industries.]

3.3 Functional Materials & Solutions

Andrew G. Stott (UBS): On margin growth in Functional Materials. It has accelerated pretty rapidly through the year. You were 90 basis points year-on-year in Q1, by Q3 you are 250. I just wonder if you could maybe put more detail around the individual business units and what specifically is driving that scale of margin growth and how you feel about that going into 2017.

Kurt Bock: Talking about Functional Materials & Solutions, I think it is interesting: Yes, we do have a margin increase improvement in Q3 compared to last year. About half of that is probably from lower raw material cost, which we do not pass on. The other half is really – that is what Hans already alluded to – savings in fixed cost, which is also important. Obviously, those are supposed to stay with us.

The margin development is a little bit volatile. We have seen steady increase over the course of 2016. I think it is too early to speculate about 2017. But our objective, obviously, is to keep margins at this level. This against a background of relatively good volume growth, which we have seen over the last couple of quarters.

What is also important: Essentially all operating divisions have contributed to that development. One business which faces a little bit of a headwind is really Construction Chemicals. They have been doing very well over the last couple of years. Right now, some markets like the Middle East, Saudi Arabia have become a little bit more difficult. That certainly has an impact. Just to give you an idea here of the order of magnitude: It's one of the five largest markets we are serving in Construction Chemicals. That certainly has an impact which we see. But across the board all businesses are doing very well this year.

Mutlu Gundogan (ABN AMRO Bank): On your coatings business: Can I just ask what the strategic importance of this business is? We know that you sold some assets to Akzo Nobel. But there have also been some other larger transactions in the industry. Can you tell me whether we should see BASF as a buyer or as a seller of coating assets?

Kurt Bock: I think, recently we came out as a buyer of assets in coatings because we have acquired Chemetall which is surface treatment, which is related to the coatings business and which will be part of the coatings division. Yes, we have stepped out of a smaller industrial coatings business which we are divesting now to Akzo because they see higher synergy and growth potential from their point of view.

Overall, it is a good business, a very, very core business for our automotive offerings overall and a very successful business as well.

Laurence Alexander (Jefferies): Can you give a little bit of detail on what you are seeing in the automotive refinish market? The softness you have seen there, is that an end market demand issue or is that a competitive pressure?

Kurt Bock: Automotive refinish coatings: In Q3, we have seen slightly lower sales due to lower volumes, both in Europe and in South America, while we had higher sales in North America. The numbers are always impacted also by FX effects because we have a very high share of business outside of Europe, especially also in South America.

So, overall, it is not an unknown development. The markets in automotive refinish are characterized by structural changes. Insurance players have a bigger impact today, the different schemes how you run the business around the globe. Overall, it has been a good business for BASF and an important earnings contributor.

Mutlu Gundogan (ABN AMRO Bank): Can you tell us how the batteries for electric vehicles business is doing in terms of contract wins? For how many platforms have you been selected? Could you give us an idea of your revenues spread? Is it mainly Japan or are you also able to tap into the high growth of the Chinese market?

Kurt Bock: On batteries: I ask you for understanding that we don't talk about individual contract wins. The business is developing quite nicely. It is a business which requires lots of resources, as we speak, in terms of R&D, developing next-generation materials. We have talked, also in my speech here, about our joint venture with TODA in North America for cathode materials. So, we are investing quite a bit including in Asia. Obviously, the big chunk of business is in Asia. That is where we are competing.

Mutlu Gundogan (ABN AMRO Bank): Would it be possible to get a revenue number, just a broad number, on this business?

Kurt Bock: No, because we don't provide revenue numbers below the level of operating divisions. Batteries is not yet an operating division; it is part of the catalysts business.

Markus Mayer (Baader Bank/Helvea): You already have elaborated on the automotive catalysts, which had a great performance. Can you shed more light on the chemical processing catalysts as well, please?

Kurt Bock: Chemical catalysts is quite a volatile business because it really depends on how the invoicing is happening. It is a project-driven business, both externally and internally, as you know, we also have captive demand for process catalysts.

We had a relatively good Q3 in chemical catalysts. Overall, we are slightly optimistic for 2016.

3.4 Agricultural Solutions

Jeremy Redenius (Sanford C. Bernstein): On the ag businesses: a strong improvement year-over-year in the third quarter. I am just wondering if you could comment on how much of that might have been, let's say, deferrals from Q2 into Q3, from the bad weather we had, affecting fungicide sprays in Q2, and how much of that might have been put forward from Q4 into Q3, as a lot can move between the quarters. I am just trying to get a sense of this quarter's performance, being the underlying or some shifting between quarters, please.

Kurt Bock: Timing issues: Difficult to say. I am not aware that we have been pushing volumes in Q3, a traditionally relatively weak quarter for the entire industry. In all fairness, we had a weak performance in 2015. Traditionally, we are at an EBIT of about 70 to 100 million euros in Q3. Last year, from my point of view, was really an exception. This year, in terms of volume developments, we have seen especially lots of market pressure in Brazil where volumes came down quite significantly. Brazil has a relatively high importance in Q3. In other markets, volumes were okay and on last year's level. So, no indications really, that we have had timing shifts between Q2, Q3 and Q4.

3.5 Oil & Gas

Jeremy Redenius (Sanford C. Bernstein): On the Oil & Gas business: It's a better than expected result there. Could you help clarify if there was anything in particular, one-off in nature that helped boost the results? Was there e.g. some more deferral of the contractual adjustments with Yuzhno Russkoye that might have pushed more of that volume adjustment into the fourth quarter?

Hans-Ulrich Engel: On the results in Oil & Gas, which, frankly, were also better than what we had expected. There are mainly four reasons for that. The first one is: During the month of September, we saw quite an increase both in oil and gas prices. The second one is: In the middle of September, we were asked by the Libyan NOC to sell and ship 800,000 barrels of oil that set in a tank in Ras Lanuf for more than a year. In fact, three days later we were able to ship this quantity. The third reason is – I already mentioned that in the beginning of the year: We did everything to reduce fixed cost in the business, including renegotiating all contracts that we have with our suppliers. As a result of our efforts, there were certain one-time compensation payments during Q3. Last but not least, we had lower exploration cost in Q3 than we usually have. But there will be a catch-up for this lower exploration cost in Q4.

So, these four reasons explain why the performance was better than what you had expected and what we had expected ourselves.

Jeremy Redenius (Sanford C. Bernstein): Thank you for that. Is it fair to say that the last three of those four were actually quite one-off in nature? If possible, can you put a value on those?

Hans-Ulrich Engel: That is absolutely correct. These are one-off in nature, but they are not special items. The order of magnitude here in Q3 is roughly 50 million euros.

Andrew G. Stott (UBS): Just looking at Q4, can you give a number on the effect of Libya with the lifting coming in October, if you are prepared to give an EBIT number? Can you just reconfirm: The negative Yuzhno impact was spread evenly through the year? That was your previous comment; I just want to check that this is still the case.

Hans-Ulrich Engel: Your question on the offshore lifting and the value of that. In the light of current oil prices, I would say that is in the range of roughly 25 million.

On Yuzhno Russkoye, I can confirm what we said already at the prior conference calls. The impact will be evenly spread over the year 2016, so evenly spread over the four quarters. So, you will see the same impact that we had in Q1 through Q3 also in Q4.

Patrick Lambert (Raymond James Euro Equities): My question is on oil and gas production, up 13 percent in Q3. Could you give us the year-to-date increase? Are you still targeting the 10 percent growth in production for the full year?

Hans-Ulrich Engel: On the year-to-date production development: It is obviously up and not quite to the same tune as the 13 percent in production increase that we have seen. It is a high single-digit number. Expectation is that we will see that also on a full-year basis.

Martin Rödiger (Kepler Cheuvreux): I just want to understand better the difference between the performance in the reported EBIT line for Oil & Gas and the net profit in Oil & Gas because there is a delta in year-over-year performance of 130 million, worse on the net profit line than on the reported EBIT line. This is despite the fact that you had a favourable tax effect, income from deferred taxes in Oil & Gas. Can you explain this discrepancy here? Was it also related to at-equity earnings, Russia? Why is the tax item not visible in your Oil & Gas reporting, on the net profit line?

Hans-Ulrich Engel: I think the missing link from EBIT in Oil & Gas to net income sits in the Oil & Gas finance line and is the result of a loan for our Norwegian activities where 1) we have the interest expense and 2) as a result of the increase of the Norwegian krone, we show actually an even higher impact than just the interest. That is the explanation for the difference that you see between the EBIT development and the development of net income.

Peter Spengler (DZ Bank): Do you consider to shut down or write down completely the Libya business, the onshore business within the next one year or so?

Kurt Bock: We sincerely hope that we have a going concern in Libya. That depends on political circumstances, obviously. That needs to be closely watched. We were taken by surprise that we could restart mid of September, as Hans explained earlier on. Everything else needs to be decided when circumstances change and we will hope that they change for the better.