

Conference Call Q3 2021 Transcript Q&A October 27, 2021

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1 BASF Group

1.1 Overall business environment

Christian Faitz (Kepler Cheuvreux): What, if any, signals are you getting from your key automotive customers in terms of production plans heading into 2022?

Martin Bruder Müller: The signals we get from the OEM producers are actually: They live from hand to mouth when it comes to semiconductors. Every week they decide, based on the availability of the semiconductors, what next week's production will be. That is also why short-work schemes have partly come up again.

We feel that most prominently and directly in the coatings business. Some OEMs have produced cars that lack components. They are actually in the yard and waiting to be completed. But you cannot produce a car without painting it. That is why we have a pretty good sensor here.

Because of the overwhelming demand which is also coming with all the devices you need for digitalization, semiconductors are short. Suppliers all work on capacity expansions which, as you also know, take two to three years. That is not a long time since the shortage became evident after the recovery.

Then there were also two outages, one in Malaysia which was related to Covid, which are basic chips in almost all cars. It really hampered their production.

I think the good thing is: The demand for cars is very high. Every car that is produced is sold. Actually, they could sell many more cars than they produce. We think that takes a little bit, until mid of the year 2022, slowly easing, step by step.

But that is something where you have to be really well connected with the customer. It is not overall totally depressing, but the hope that this year will have significant production increases will not be fulfilled. We will see production levels slowly coming up in 2022.

Christian Faitz (Kepler Cheuvreux): Do your own assets face any noteworthy logistical or supply challenges at this point in time?

Hans-Ulrich Engel: I could start with the beginning of the year, the freeze at the U.S. Gulf Coast, continue with the Suez Canal, go to the COVID-19-related closures of Chinese ports on the East coast, congestion at the U.S. Pacific coast. I could go on and on and throw the hurricanes Ida and Nicholas in there. This is a continuous challenge that we are facing. This is maybe the wrong place, but it's maybe the right time to say a big thank you to the BASF team for how they have handled the entire situation.

Are we affected? Yes, we are affected. To give you an idea: The freeze at the U.S. Gulf Coast has led to shut-downs of chlorine plants and the issues with that continue and have an impact on isocyanate production in the U.S., a force majeure as a result of that declared and still ongoing.

We have a number of force majeure situations due to supply chain issues that unfortunately our customers are very much aware of. We are doing what we can. Has this led to situations where we had to shut down production? Not really. We were able to cope and manage. But it has clearly an impact on the business.

But it is a situation that, when we saw how quickly demand came back, we – I don't want to say – had expected, but something that to a certain extent we had at least foreseen, going back to the year 2010, when due to increased demand then, we have seen lots of similar issues.

You can't prepare for them. You can only try to handle them in the best possible way and that is what we are trying to do.

Matthew Yates (Bank of America): When you took over as CEO, you highlighted a desire to change the commercial culture and accountability of the downstream units. That is very, very difficult for us to assess that over the short-term quarterly numbers, especially given the noise we have at the moment around volatile raw materials.

But given this was a quarter when most of your downstream units reported profit declines: Can you talk a little bit about how these businesses are operating differently to perhaps they were three or five years ago in trying to systematically demonstrate the sort of pricing power you have in these businesses that can drive higher profitability through a cycle?

Martin Brudermüller: This is certainly not an easy question to answer, but let me say this first: When we decided that we go for more differentiation, but on the other hand also simplification and then also empowerment by embedding and delegating more to the divisions, we are very happy with that result.

The divisions have more of an "own character" to adapt to what is needed by their markets. I am very happy with this development. Along with this came a hunting spirit.

You know that BASF was not growing enough in volume for many years. So, I think if you look now, already in the difficult time of the pandemic, we have done well with volumes. Now, in this very dynamic environment, we are even higher with our own dynamics. We have managed to implement a different mindset, to really go more for the market, fight for volumes, fight for market share. I think that was also helped and underpinned by the embedding.

What you see now, on the other hand, is very much the topic which is not a new one to BASF. You know: When we have very aggressive raw material price increases, then the downstreams always struggle to pass it over as quickly as it is needed. We have talked about that many, many times.

They have raised prices. You saw also that all the volumes, except for those with automotive, have raised greatly. So, they are in the business, they are with the customers, but they struggle with this time delay in passing over the cost. You know that we have for good reasons, prices that are not always related to raw material costs because we actually price for an effect and for a value added on the customer side. That means, however, if your price pressure is up, you cannot go there and say, "Now I have a different logic in this moment and now I want to raise my price because of high energy and raw material. – That is why they need more."

On the other hand, it is also very clear: The higher the prices get, the more resistance on the customer you have to go for even higher price increases. That is why I said at the beginning: The good thing is that all the businesses confirm that there is a strong demand. As long as you have more demand and supply, even at high prices, you still have some pricing power to go even further. That is actually what has to happen over the next months. Should then the margins normalize, on the one hand, the pressure is easing. And for those who have linked into these prices, they have actually a margin increase because the price will also not go down as fast as the raw material.

So, this is always the problem on the downstream side: If we have these large changes and this steep slope, it needs time.

So, yes, we have the one or the other topic and we made that also very transparent to you with the vitamin A 1000 powder, which is an in-house problem of BASF – very clear; that is why we have also highlighted it and we are anything but happy about it.

But beyond that, from an operation mode, also from the feedback we get from the customers using the right instruments, I can see that we have rising customer confidence with BASF throughout the businesses.

That shows me that the downstream businesses do a better job than they have done in the past in satisfying their customers.

But I think we have also an exceptional situation now: Raw material prices is one thing, energy another; we have talked about that. But what is also awful is transportation cost. If you look at what a container costs from Ludwigshafen to China, it is a mind-boggling price increase. But then, if you have agreed to the price, you are not even sure you get the container as such.

So, it is a lot on the load. We are not happy with the earnings mix, very clearly. I expressed this also openly. But in principle, how they move in doing business, I am really satisfied.

Rob Hales (Morningstar): I am just wondering: On Chemicals and Materials, can you give us an idea where current spreads sit right now versus historical averages? What is the extent of industry force majeure right now?

Martin Brudermüller: Well, that is not so easy to answer for the segment as such because there is a logic on each and every one in the line. But with many of the key products we are talking about, whether this is MDI, whether this is acrylic acid, whether this is BDO, we have a margin far above the average of the last five years. This is what I said at the very beginning. I don't want to quantify that, but it is significantly over the five-year average. This is also why this cannot be a new normal to only slightly come down. It will come down with more availability.

But I really want to make clear that there is not coming a negative tone now that we run into a disaster with margins upstream; we just talk about a slight normalization. Going forward, at least for the next months, we will see them on a very attractive level in the upstream business. So just don't get that in the wrong way.

I really would like to say again: You see us here in a positive mode. You saw that the guidance was taken up. Two months before we come to year end, we raised this again significantly.

Besides the automotive industry, which is a little bit hand-to-mouth, no one can say. Actually, all remaining businesses have strong demand, and we see this also continuing in 2022.

The only question is now to handle the shortages everywhere. But based on that, it is more a production and availability topic and not a demand topic.

I would be much more concerned if it were the other way around. We will certainly update everything in February when we give you the final numbers for 2021 and then also an outlook that goes a little bit beyond what I have said today.

But we should now really say: We will get this year over and finished in a very good manner and we will also start next year very well. That is maybe my final message.

1.2 Inflationary environment

Andrew Stott (UBS): On energy costs: My rather rudimentary back of the envelope gave me a much bigger number than the energy inflation you pointed to in the slides. To what extent has hedging protected you so far? Is there a broad guidance you could give for 2022 on energy costs if we just assume spot persists, which may not happen? A rough guidance on current sensitivities.

Hans-Ulrich Engel: A rough guidance on energy costs; that is actually a good one. What have we provided you with? We have provided you with the 600 million euros in additional costs that only relate to European gas purchases. That is what we have given you.

You are right: In total, when we look at the situation, the cost impact is obviously on the energy side, but also, if I go broader, on the raw material side much higher than that. If I look at raw materials in total – I only compare Q3 this year with Q3 last year; and this is only the price impact – it is about 2 billion euros price impact, in other words: cost impact, if you leave raw material volume at the same level. That comes here from prices. That puts a lot of pressure, obviously, on the system, but also on our businesses because the clear expectation is that these prices are passed on.

With respect to Q4, giving guidance is extremely difficult. Coming back to natural gas prices in Europe, you have seen natural gas prices in Europe during the course of this month, spot prices at levels of 140, 150 euros per megawatt hour. Currently, we are sitting at a level of 88 euros per megawatt hour, so a significant decline. But this is six to seven times, if I think back, of where we were in the beginning of this year.

So due to the volatility, please understand that I can't give you a specific guidance. It is a very interesting situation that we are in and that we have to cope with. There is significant cost pressure coming from raw materials in general, natural gas in particular, and, with that, energy. It's also clearly reflected in the results.

But so far, if you look at Q3 earnings, as I said, we are able to cope with it.

Andreas Heine (Stifel): On the gas price regime in Europe. In historic times it was linked to oil with a delay of three to six months and now you have most of that in spot. Would it be ever possible to go back to, let's say, this smoothing kind of process for you in the gas price contracts or is that simply impossible and it will always be linked to spot and if you are not happy with spot, then you have to buy financial hedges?

Hans-Ulrich Engel: Yes, as we say, most contracts in Europe are now based on spot; that has developed over the last years. As always: Can I exclude that this will move back to a more longer-term pricing regime? I can't exclude that, but the market compared to where it was five years ago has changed quite a bit. This is what it currently is.

Depending on how you think about it: You have the immediate impact based on a spot price regime where you need to act immediately versus something that comes with a time lag of three to six months – frankly, I don't know what is better. Somebody who is willing to take things head on. So if you need to deal with it, then you deal with it in the very moment that it actually happens.

1.3 Regulatory framework

Andrew Stott (UBS): More broad-brushed around China. I saw at the weekend the Chinese government or the NDRC more specifically put out some targets for closures across the petrochemicals industry. I just wondered what your first thoughts are on this policy.

Martin Brudermüller: I am not totally sure what exactly you mean, whether this is the energy-related topics the NDRC communicated. They communicate continuously something.

Andrew Stott (UBS): It was specific to some of the decarbonization plans. They talked about and emphasized potentially closing smaller facilities across China, mainly in ethylene and ammonia. I just wondered if you had any thoughts on that.

Martin Brudermüller: Overall, I would say: This is a positive development. Actually, I would also say: The energy shortages are to a certain extent also a positive sign from China. We are complaining now, but that is actually also showing that they take CO₂ reduction and energy intensity seriously. That they shut down partially their industry, knowing that this goes on cost of GDP, because the guidelines and the KPIs for energy consumption and with that also for CO₂ emissions have been exceeded, is a very good sign.

They go after the energy-intensive industries and the chemical industry is one of those. There are tremendous inefficiencies in the chemical production landscape in China. There is a lot of coal-based chemistry. I like that actually, as one more step among many to basically go for structural improvement of the chemical industry. That means clustering them and shutting down those that are inefficient.

That is overall great for us, because that is bringing the industry benchmark closer to what BASF is doing anyway.

We showed you also at our Capital Markets Day how we address CO₂. I have to say: When we have the new site in Zhanjiang, a lot of competitors will look pretty ugly when it comes to CO₂ emissions, and I am quite sure: It will put pressure on them that they have to do something about it.

It is a little bit similar like we had ten years ago with EHS where we were operating on a high level and the industry was on a much lower level. Now, in the meantime, EHS is a tough issue in China, so they are forced to produce under the same circumstances. With this, we have more a global level playing field.

I very much like that and I would say we should acknowledge that China is not only about building coal-fired power plants, but also curtailing CO₂ and energy intensity.

Andrew Stott (UBS): Are any of your sites affected so far?

Martin Brudermüller: We had a small problem with the new Shanshan asset because they have some production in the provinces that were far above their energy consumption allowance. But on the other hand, for example, in Nanjing, we have with the Verbund a very energy-efficient setup. We were actually praised because we need much less energy per value added in chemicals over there.

So, when you are benchmarked there, they don't shut you down, but they shut down the inefficient ones. In this environment, that is really a competitive advantage.

Tony Jones (Redburn): There have been some recent headlines and rumours that the EU Commission is changing its stance in terms of border tax for the chemical industry. Could you maybe give your own perspectives on that and whether you see that as a net positive or negative for BASF?

Martin Brudermüller: On the border adjustment measures, I am clearly addressing that. I don't think that this is an appropriate measure. It is very, very complex. It is bureaucratic and it does not really help to address the problem because you have to then control also all the consumer products finally that contain certain chemicals with CO₂ emissions. I ask myself: How do you want to bring that transparency in? And it actually invites that you don't play anymore in the basic products, but you import further value-added products into Europe which are not covered at all with the border adjustment measures.

That is why we in the European chemical industry have decided not to really push for participation in the border adjustment measures. We are now only included with ammonia and fertilizers, where it is totally unclear how that should work.

Just to give you an example: If you don't import ammonia and fertilizer, but you import melamine, which is a downstream product for ammonia, you actually escape the border adjustment measures. I think it is not an appropriate measure. For BASF, the effect is low at the moment, as it is designed, because our strategy is to produce in the regions for the regions. That means we don't have a big product flow for these kinds of basic products. We don't export ammonia into other regions. But certainly, we will be affected a little bit with those products where ammonia is directly the cost impact there.

But you know: A lot of our ammonia is used internally in the Verbund. So, we go further down to amines. We use it for the production of isocyanates which have higher margins. In that respect, we will be fine and not so much exposed.

But I think this whole instrument will be a bureaucratic monster and in the end, it will also not conform with the WTO.

1.4 Bonus provisions

Tony Jones (Redburn): I wanted to come back to the reallocation of the bonus. Could you help us understand which divisional metrics now will trigger the bonus? Or is it still at the group level? The reason why I ask that is: It is good to know from a modelling perspective, but it looks like there was a provision in Agricultural Solutions, but the EBIT was lower than we expected. So that would be good to know.

Hans-Ulrich Engel: Let me try to put things in perspective. The bonus that we pay, so the variable compensation at BASF, is based on the group's return on capital employed. That is the basis for the bonus payment. Then there is an individual component when it comes to the individual employee. But irrespective of which part of BASF you are in, the basis is that the bonus pot gets filled on the basis of return on capital employed.

Last year was a year where, due to the very low results that we generated, we paid out bonus in the order of magnitude of 400 million euros, so 400 million euros for the year 2020. At target, we are at, let's say, roundabout 1 billion euros. So that is when the return on capital employed is at 10 percent.

This year, we have accrued so far 1.3 billion euros. So, if you compare 2020 to 2021, there is an additional roundabout 1 billion euros that we have accrued so far.

How do we do this? We do this typically on a pro-rata basis. This year, due to the development of our earnings, we made certain accruals also in Other. I hope that with that I will be able to also answer a question that is most probably to come: What happened in your results for Other?

This accrual that we had in Other of roundabout 200 million euros for the third quarter, we reversed then in Other and allocated it to the operating divisions.

So, from a personnel cost side, a significant increase as a result of the provisions for the variable compensation and the sort of odd result that we were seeing in EBIT before special items in Other.

The big swing that we have there compared to Q3 2020 is explained by the fact that we had about 200 million euros of bonus accruals sitting there, which didn't evaporate; but we moved it out of Other now in order to have the divisions properly provisioned and sort of burdened the provisions with these 200 million euros. I hope that explains your bonus question in general on the one-hand side, but then also at the same point in time what is happening in the results of Other in Q3.

Chetan Udeshi (J.P. Morgan): Just going back to the allocation of bonus accruals to individual divisions. I think it is probably the right thing to do because then it improves the transparency in terms of how BASF's divisions are doing versus the others.

I am just curious: Is this something which is going to be a structural change, i.e., are you going to do that in the same manner in the future?

And, related to that: I think you addressed previously that essentially it is BASF's performance which is what drives the bonus pot. Shouldn't there be a more nuanced approach to how individual businesses are rewarded?

Just looking at the ag performance this year, it seems quite difficult. I am surprised that there has been, at least it seems, quite a big chunk of bonus accruals that has gone to that business. How do you actually reward individual businesses if the majority of the bonus accruals are based on BASF's own group performance?

Hans-Ulrich Engel: We are following a consistent approach. In the end, the bonus allocations will be made to the respective divisions. They are based on the respective headcount of a division. Our biggest division from a headcount perspective is our Agricultural Solutions division. Yes, they are also being burdened there on a relative basis with the highest bonus provision.

The discussion about what you do and how you run a group, whether you fill the pot for everyone the same way or you differentiate, is actually one that we had many, many times. We came to the conclusion that for the BASF Group, it is the best way to have a bonus that is being paid on a similar basis for everyone working in the BASF Group, but then to differentiate, in the end, based on the performance of the respective business and the performance of the respective individual. I think that has worked very well for BASF.

1.5 Wintershall Dea

Jaideep Pandya (On Field Investment Research): When you do IPO Wintershall Dea and I assume eventually you want to exit Wintershall Dea, how are you going to be hedged physically for naphtha and for natural gas from a long-term point of view?

Hans-Ulrich Engel: Without the Wintershall Dea business, I don't see too much of a physical hedge there anymore. This will be a situation where we will have to turn more in the direction of financial hedges to the extent that raw material price developments are not fully reflected in the respective sales price formulas.

Chetan Udeshi (J.P. Morgan): There were some comments on IPO of Wintershall Dea on Bloomberg. I just wanted to check what was actually said because it says, IPO of Wintershall Dea wouldn't be reasonable in the mid-term. Are you guys changing the stance on what you want to do with the ownership of Wintershall Dea?

Hans-Ulrich Engel: Has our strategy with respect to Wintershall Dea changed? – No, absolutely not. I think we have been absolutely consistent in what we said: that we want to exit that business over time, that we want to IPO the business. You know the reasons why we called off the IPO for 2021. I think we were also absolutely consistent in what we said: The next communication about the IPO will be at the point in time where we have decided to go live.

1.6 Dividend and capex

Markus Mayer (Baader Bank): The question from my side would be on your cash flow. You said there is a negative effect from that from capital outflows, so basically the reason for a lower free cash flow. What are your expectations for net from capital outflows in the fourth quarter? The related question is: Do you expect to pay a dividend from your free cash flow this year?

Hans-Ulrich Engel: Q4 is traditionally a strong cash provider for BASF. We expect Q4 of this year to be a strong cash provider for BASF. Do I expect to pay a dividend out of free cash flow for the year 2021? – Absolutely.

Peter A. Clark (Société Générale): The capex, I presume, is still on the 3.6 billion euros. I know you spent 1.5 billion euros in the final quarter before. I just want to clarify that.

Hans-Ulrich Engel: On the capex: 3.6 billion euros is the guidance. As it looks right now, we may come in slightly below that, but it remains to be seen what the spend actually will be in Q4.

2 Segments

2.1 Chemicals

– no specific questions –

2.2 Materials

– no specific questions –

2.3 Industrial Solutions

– no specific questions –

2.4 Surface Technologies

– no specific questions –

2.5 Nutrition & Care

– no specific questions –

2.6 Agricultural Solutions

Jaideep Pandya (On Field Investment Research): Around Agricultural Solutions: Could you just share some color on the dynamics you are seeing in, for instance, canola, given the drought situation in Canada, but also very high prices? Going into 2022 season, do you see a normal ag season, or do you think that extreme weather in Brazil and North America along with high fertilizer prices and logistics costs are going to have a negative impact on farmer demand?

Hans-Ulrich Engel: On Agricultural Solutions, what is the situation there? I will focus on the Northern hemisphere and on ending inventories in the sales channels.

In the ag industry, we have experienced very good demand, strong demand in the Northern hemisphere. As a result of that – let me quickly think about this – in Europe it looks like the season ending inventories are at a decent to good level. We are not faced with a situation where there is oversupply sitting in the channel.

The same is true in general for North America, with one exception and that exception is Canada where, due to the drought situation, the channel inventories are elevated at this point in time.

Soft commodity prices, as you know, have moved up significantly compared to the prior year or, you could even say, the average of the last five years. We have seen them coming down a bit from the peaks that they had reached in July. But I would call the prices for soft commodities robust. If you think about soy, currently, I think it is about 12 US\$/bu. You have wheat at above 7 US\$/bu; you have corn at above 5 US\$/bu, so all compared to average of the last three to five years certainly elevated. That usually leads to a good, strong demand.

You hinted at what is to be expected as a result of high natural gas prices and high ammonia prices, which are high fertilizer prices. Yes, that may play a role in the decisions that the farmers will make then for the next season. But looking at what is currently happening in South America: While we are not happy with the result that ag has generated in Q3, you see us with a volume increase of 7 percent and that clearly reflects the good, strong demand that we are currently having in South America.

With that, I think, we will go into what I would call an overall good season in the year 2022 for the ag business.

Andreas Heine (Stifel): You said and emphasized that in ag the price increases can be only done once in the season. Now, going into 2022, especially for your seed business, would you share just in qualitative terms how much you might be able to increase prices?

Hans-Ulrich Engel: About the price increases in Ag: Let me put it this way: We missed the boat and now in the second half of this year, the task that the team has is very, very clear. Also considering the overall cost development for the business and the soft commodity price environment, there is room for potential improvement, and we will certainly go after that.