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JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Covestro Investor Conference Call on the Q2 2017 Results. The company is represented by Patrick Thomas, CEO; Markus Steilemann, CCO; and Ronald Koehler, Head of Investor Relations. (Operator Instructions)

I would now like to turn the conference over to Ronald Koehler. Please go ahead, sir.

Ronald Koehler - Covestro Aktiengesellschaft - Head of IR

Good afternoon, and welcome to our Q2 conference call. Beside Patrick, which you all know very well, I'm happy to welcome now, first in time, Markus, on our quarterly conference call. As you know, he's our Chief Commercial Officer and appointed successor CEO.

For your information, we have posted our Q2 interim report on the conference call presentation on our website. We assume you have read our safe harbor statement.

I would now like to turn over to Patrick.

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

Thank you Ronald and good afternoon everybody, and welcome to our call. In quarter 2, we faced a constrained core volume development with a minus 1.6% year-on-year decline due to limited product availability, particularly in Polyurethanes and Polycarbonates, plus some negative phasing effects in CAS. However, this was broadly in line with our expectations as guided during the quarter 1 conference call at the end of April.



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

Overall, we delivered a 3.5% core volume growth in the first half of 2017. We believe that the demand for Polyurethanes and for Polycarbonates markets remains solid, confirming the growth trend of 1 to 2 percentage points above global GDP development.

Despite the constrained volumes, we could further impressively improve our earnings with a year-on-year EBITDA and EPS increase of 56% and 112%, respectively.

Our ability to generate high free operating cash flows was once again confirmed with a year-on-year growth of 35% in quarter 2, despite significantly higher working capital.

We can now fully confirm our guidance for the full year 2017 and also our long-term ambition to deliver a cumulated free operating cash flow of EUR 5 billion for the 5 years from 2017 to 2021.

I'd like to provide you with some more insight into our core volume growth by region and industry. In quarter 2, our volumes suffered from our limited product availability in all regions. In Europe, we faced a scheduled maintenance turnaround in Polycarbonates and a smaller production disruption in MDI. In Asia, we underwent a maintenance turnaround in TDI. And in the U.S., we faced limitations in polyols.

As we have now reached a rather high global utilization rate, we are now focusing on our most attractive applications. We are now in the phase of selling up, increasing the proportion of our higher value-added products in our portfolio. This follows our previous years of selling out. As an example, we achieved strong growth rates in automotive and medical in quarter 2 and in the full first half. These customer industries are especially strong in our core countries. And due to limited volume available on our side, this led to a more than proportional decline in peripheral regions in Africa and Eastern Europe.

Our sales development in the second quarter of the year continued to be very strong driven by all business segments. Similar to quarter 1, again, all 3 components, volume, price and FX, positively contributed to the growth, although to a different extent. The main driver of our top line growth this quarter was significantly higher selling prices, especially in Polyurethanes, which accounted for 15.3% year-on-year.

The slightly positive volume development is explained by our product mix upgrades. As we sold more of the higher-priced products, we were able to generate a positive volume growth in Euro terms despite declining volumes in kilotons.

Our EBITDA improvement in quarter 2 was on a similar high level as in quarter 1. We grew EBITDA by 56% versus the prior year quarter. This was mainly driven by a strongly positive pricing delta in TDI and MDI.

With regards to other effects, we had a positive impact of 2 one-time items: firstly, the EUR 35 million insurance payment for the force majeure case in 2016; and secondly, a EUR 39 million book gain from the disposal of the U.S. spray foam business closed during the second quarter.

EBITDA margin improved from 18.1% to 24.2% in quarter 2. However, it should be put into perspective, excluding the one-time items, our margin would have been 22.1%, a level we deem more appropriate to reflect this quarter's performance.

In a quarter-on-quarter comparison, our underlying EBITDA margin slightly declined due to the lower core volume growth.

I will now hand over to Markus, who will give us more details on our business segments.

Markus Steilemann - Covestro Aktiengesellschaft - Chief Commercial Officer and Member of the Board of Management

Thank you Patrick and good afternoon everybody. Demand remains strong for Polyurethanes. However, the industry now operates at its limits considering the available capacities. Actually, it is becoming clear to us that models based on a theoretical nameplate capacities overstate the available production capacities. They do not take into consideration the possible feedstock limitations at several plants. As we have seen, every smaller production interruption currently results in an industry shortage. Therefore, we welcome new capacities, as it will support our customers on their growth path.

JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

Our growth in core volumes was constrained by limited product availability, as explained by Patrick. Still, looking at the first half year, we delivered a solid core volume growth of slightly above 2%, despite declining volumes in polyols.

Looking at the different customer industries, the core volume growth reflects the focus we had to put on core applications. Thus, the main drivers were electronics and automotive. As you can see on the two bars showing EBITDA in Q1 and Q2 2017, we highlight the EBITDA attributable to one-time items and to what we call fly-up margins. We believe this is in the interest of higher transparency. We consider the remaining EBITDA of around EUR 350 million per quarter achieved in Q1 and Q2 as the appropriate comparative basis for your future forecasts.

For MDI, we assume that the annual industry utilization rate will remain on the currently high level as supply and demand is expected to grow at a similar pace until 2021 and possibly beyond. Please note that we, at the current growth rates, need a new world scale plant every 8 to 10 months in order to allow for an adequate industry supply.

For TDI, the current industry tightness led to fly-up margins in the first half year. In Q3, we again expect a very attractive margin level, however, somewhat lower compared to Q2 due to new capacities expected to enter the market. We currently assume normalization of industry margins towards year-end. This is based on our assumption that the plant in Ludwigshafen will run smoothly and that Sadara will ramp up its production without any problems. As history have shown, this may be a conservative assumption. In the case of any further delays, the market could stay tight for quite a while.

In Polycarbonates, our core volume growth was only slightly positive in Q2 2017, mainly due to the high comparable basis coming from our capacity extensions available in Shanghai since Q2 last year. On top of this, our product availability was limited in Europe due to preparations for plant shutdowns and low inventories.

For the first half year, we delivered a strong core volume growth of 7.5%. Growth was broad-based, driven by all three regions. We achieved double-digit growth rates in automotive, electronics and medical.

In Q2, EBITDA increased by only 3.1% year-on-year helped by product mix improvement. However, we experienced a negative pricing delta in Q2 due to higher raw material costs. We purchase most of our raw materials based on monthly contracts, whereas our selling prices are mainly fixed for 3 to 6 months, especially in Europe and North America. Based on recently renewed contracts, we are confident of catching up in the second half of 2017.

In Coatings, Adhesives and Specialties, our core volumes decreased 3.0% year-on-year, mainly driven by the volume phasing we described in our last conference call. Last quarter, we reported volume growth of 8%, while the reported growth rates of customers were around 2% to 3%. We assumed prebuying activities end of Q1 ahead of our announced price increases as of April 1st. Volume development in March, April and following months confirm this view. Nevertheless, for first half year, it brings us to a solid core volume growth of 2.3%, in line with the assumed end market growth.

EBITDA decreased by 19.7% year-on-year to EUR 114 million affected by the negative volume leverage, but foremost by higher raw material prices. For example, butadiene prices reached a significant peak in Q1, and this hit our P&L in the second quarter. After 9 consecutive quarters of declining selling prices in major product groups, we have now successfully implemented the first price increases. However, as most of our contracts run for 3 to 12 months, we need a bit of patience before we see the full benefit.

We achieved 0.6% year-on-year price increase in Q2. We are confident that prices will continue to slightly improve during the coming quarters. At the same time, we expect some relief from raw material cost during the second half of 2017. As a consequence, we assume that the temporarily low margin will start to normalize again.

Now back to Patrick.



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

Thank you Markus. So in the first half year, we were able to generate a record free operating cash flow of EUR 530 million. The strong improvement was driven by the EBITDA increase and the very low income tax payments. Components, partly offsetting it, were a negative working capital contribution, higher CapEx and the payout of bonuses.

Working capital-to-sales ratio temporarily reached 18.8%. This was mainly driven by higher selling prices which led to higher values in inventories, despite only slightly higher inventories in kilotons and higher receivables. Overall, we're confident that we will be back into our target range of 15% to 17% of working capital-to-sales ratio at year-end.

The benefit from the low cash tax rate is purely a phasing effect. For the full year 2017, we expect tax payments in line with the effective tax rates of around 28%.

Finally, the release of provisions was driven by the payout for the 2016 short-term bonus program in the first half 2017. During the remaining year, we will continue to build bonus-related provisions for the full year 2017.

The ratio of total net debt to EBITDA slightly decreased further to reach 0.9x at the end of June compared to 1.3x at the end of last year. As you know, a total debt-to-EBITDA ratio of 1.5x is adequate for a solid investment grade rating. And as stated at our Capital Markets Day, we are looking to use excess cash to value accretive acquisitions or cash returns to shareholders.

We reiterate our guidance of a low to mid-single-digit core volume growth for the full year 2017. Our ability to generate a solid growth is now determined by the focus on operational excellence as we run our assets at high utilization rates. Therefore, the core volume growth over the coming quarters will heavily depend on the realized production compared to the previous year's basis.

As a reminder, we achieved a rather high output in Q3 2016, whereas Q4 2016 suffered from a severe production issue caused by insufficient feedstock supply in Europe. We continue to assume a free operating cash flow for the full year 2017 significantly above the average over the last 3 years. We also expect a further improving ROCE, leading to a level that will significantly exceed that of 2016.

On EBITDA, we also reiterate the guidance that our EBITDA will significantly increase for the full year compared to 2016. For the EBITDA in quarter 3 this year, we foresee a significant year-on-year increase. The industries remain tight and global demand growth continues to be healthy. As a consequence, we assume that we can achieve a year-on-year pricing delta of around EUR 200 million in quarter 3, almost as good as in quarter 2.

Let me now close our session before Q&A with a summary. We saw some favorable changes in the industry over the last quarters, the continued robust demand being the most striking. The respective consequences will influence our investment case for the years to come. We continue to commit to deliver organic growth above global GDP, which supports a stronger earning and cash flow generation. In order to lead the growth of our industries, we focus on a smart CapEx approach to extend our capacity short term. We will also consider new options in order to drive our long-term growth. With the high amount of cash generated, we are looking more intensively into clever uses of cash, fully focused on value creation. Having said this, we are strongly committed to return excess cash in the form of special dividends or share buybacks in case we make no use of it by mid-2019.

We often get asked about our sustainable earnings level. And after more than 40 years in the industry, I would like to use this opportunity to give you my personal view on this question. Pre-financial crisis, Covestro, in its previous form, generated a sustainable EBITDA level around EUR 1.7 billion between pre-crisis and today, predominantly in China. These investments clearly have to deliver an adequate return. As a consequence, I see the EBITDA level of around EUR 2 billion achieved in 2016 as a minimum required earnings basis. Then I would add the ongoing positive volume leverage and targeted cost savings. This calculation shows you how I assess Covestro's future earnings potential based on a normal GDP environment.

Thank you for listening to us, and we are delighted now to be open for your questions.



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question today comes from Patrick Lambert from Raymond James.

Patrick Lambert - Raymond James Euro Equities - Research Analyst

Two questions, please. The first one concerning your visibility on the EUR 200 million bridge in Q3. Would it be possible to get your views on the different divisions? I would assume that PUR will still be the major part of this EUR 200 million. But how do you see Polycarbonates and CAS contributing to the EUR 200 million? That's the first question. And a very simple one on payables. The shop drop in Q2, just to understand, was it really linked to the shutdowns or anything else in those move?

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

Thank you Patrick, for your question. I'll take the first one on the EBITDA EUR 200 million bridge on pricing delta. Yes, you're right. It probably is dominated by PUR, but we also see upside on Polycarbonates returning to price recovery. And we also see CAS coming back to a more normal level of EBITDA, primarily there because of the price increase rolling through as we continue the process of pulling up prices in CAS, which is, as we said in the speech, a long process. And Ronald, along the second question, Markus?

Markus Steilemann - Covestro Aktiengesellschaft - Chief Commercial Officer and Member of the Board of Management

Yes. Patrick, on the 2 shutdowns, if I get it correctly, that you were referring to, we estimate that the product loss was around 10 kt max.

Patrick Lambert - Raymond James Euro Equities - Research Analyst

And in terms of payables, in particular in the working capital, that was the shoppers drop of the working capital. Is there anything special it?

Ronald Koehler - Covestro Aktiengesellschaft - Head of IR

Okay. In terms of working capital and payables, I'm not sure which you compare it either to end of Q1 or end of Q4. Versus end of Q1, the payable actually was negative because raw material prices came down. And therefore, we have less payables and outstandings. So therefore, a burden to working capital versus end of the fourth quarter. Actually on the half year figure, we have the effect that in the force majeure situation we had that we bought a lot of, let's say, intermediates, which were higher price and higher cost, and that cost is higher outstanding payables. So obviously, it's bit of a phasing effect. As we said before, we are confident to go back into the 15% to 17% working capital stage ratio range end of this year. And therefore, we might have seen the peak of negative working capital impact now end of Q2.

Operator

The next question comes from Laurent Favre from Evercore.

Laurent Favre - Evercore ISI, Research Division - Senior MD, Head of Global Chemicals Research and Fundamental Research Analyst

Yes, 2 questions on CAS, please. The first one in terms of margin, so you're talking -- I think in the slide about a quarter below par. And that's the goal -- from memory, par for CAS was 23% to 24% EBITDA margin. Is that still the margin target for this year? Or is that still the indication for this year and for the years to come? That's the first one. The second one is on the inventory cycle, if you want, for the division and the customer purchasing



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

cycle. You talked about volumes being below your customers, but customers so far have reported volumes between flat and minus 1% or 2%. So I'm just wondering how can you be considering that in Q3, we will not see again a quarter with your customer ordering less from CAS.

Patrick Thomas - *Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO*

Thank you, Laurent. Let me just try and answer your first question around the margins because that's a very important question. So in quarter 2, the EBITDA margin was affected principally by negative volume leverage because of lower core volume growth. Secondly, the very high raw material prices. Butadiene for us is purchased internationally. And our price peak was in quarter 1 and that hit the P&L in quarter 2. We already know what the pricing levels will be for quarter 3. And we're confident that we'll return to a more normal margin level. And then thirdly, we are in the process of increasing prices on a range with our CAS products. We announced it in March. And they will have an impact principally during second half. Therefore, if I look at EBITDA margin for CAS, it was around 23.7% for the first half. And we remain committed to the corridor that you gave of 23% to 24% for the full year. So that would be a spot on exactly what you are suggesting. Your second question was around inventories on CAS, I think. Can you repeat your second question? Sorry, Laurent. I've lost it.

Laurent Favre - *Evercore ISI, Research Division - Senior MD, Head of Global Chemicals Research and Fundamental Research Analyst*

Well, Patrick, I was saying that so far, your customers, so PPG, LTM, Akzo, et cetera, HB Fuller, have reported volumes that have not been 2% to 3%, but more minus 1%, 2%. So I'm wondering to what extent you have visibility on their inventories of raw materials that would give you confidence that you can grow in CAS in Q3, the flipside being that maybe they still have inventories of those cheaper raw materials and that, again in Q3, they can delay purchases.

Patrick Thomas - *Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO*

Yes, it's a good question. So I was looking at the results of some of those customers that we have, which are publicly quoted and very available. They don't represent a very, very large part of our market because we also sell into the elastomers business, we sell into the adhesives market, we sell into the films market in our CAS business. It's a whole series of specialties. But you're right. The performance coatings part of most of those companies has seen quite slow growth. And we also see that slow growth in our mix. So there is a complete line-up between the public reporting of PPG, of Sherwin-Williams, Valspar, all of those companies, AkzoNobel, and their experience in the industrial coatings, which is largely driven by infrastructure projects and civil engineering projects. We see the same effect, where we serve the active ingredients for those. However, we still believe our CAS business will experience a full growth rate for this year roughly at or around GDP, which is the normal growth rate we would see in CAS.

Operator

And the next question comes from Mr. Peter Mackey from Exane BNP Paribas.

Peter Mackey - *Exane BNP Paribas, Research Division - Analyst of Chemicals*

Sorry to stick on CAS division, but a couple of questions there. The first one, if the price increases, if the contract structure of pricing in CAS spreads the price increases over 3 to 12 months, why do you think you have such aggressive prebuying in the first quarter because presumably, customers would have had 3 to 12 -- or 0 to 9 months to buy product before those price increases? And I suppose that's sort of extension of Laurent's question about how much visibility and confidence you have about your customers' buying patterns. And the other question I had is, apologies to remind you of this, but at the first quarter stage, I think you've guided in the Q&A to a margin in CAS pretty much in line with the first quarter. And obviously, it's fallen rather shorter than that. You must have had at that stage some visibility of butadiene price impact in the second quarter. And so I wonder what caught you out in Q2? That's the question, I guess.



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

Okay, Peter. We're very happy to take the questions on CAS. We like good questions on CAS. So on the pricing question, it's quite an interesting mixture effect. So what you have is a whole load of Asian customers who are short-term contract or spot buyers who bought ahead of price increases. And we certainly saw that effect in this multitude of customers that we have. Remember, we have some 4,000 different customers in CAS. And the customers we're talking about, which are longer term, much more often in Europe and in North America. And within that group, you'll find some of the famous names who are holding out longer and can hold out longer because of either contractual terms or because of negotiating position. But we're confident that we will restore the margins back to the original level corridor, as predicted. I don't remember offering a promise that the margins would be anything other. I don't remember that promise. I usually remember my promises. So I'm surprised by that. I'm certainly looking at the numbers we had available there are, which are in front of me, then we did actually, at the beginning, expect that this margin effect would kick in. So yes, I'm sorry if I have misled you in a private conversation or something...

Peter Mackey - Exane BNP Paribas, Research Division - Analyst of Chemicals

No, no, no. I just saw my notes from the 1Q call. Similar margin in 2Q as in 1Q in CAS. Maybe, I must have taken this down incorrectly.

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

No, sorry. We must have said something that misled you. I'm really sorry. But at that point, we knew the butadiene effect was there because we pretty much, as now, we can see the butadiene effect for quarter 3 because of our procurement strategy. Yes, there is a lot of confusion on butadiene because most people follow the European pricing for butadiene. But we buy on a global basis. And if you track Asian and American prices on butadiene, then you can see possibly how we purchase in quite a complex sort of inter relationships. So we took the biggest price hit in quarter 1. And if you look at the numbers, it's always the factor of 3 from the normal effects, the normal pricing level and that rolled in quarter 2. In quarter 2, we've seen those prices dropped and that will impact positively in quarter 3. We have pretty high visibility on raw materials. So is that okay?

Peter Mackey - Exane BNP Paribas, Research Division - Analyst of Chemicals

Yes, just -- sorry, yes, absolutely. I did have something -- one thing in mind. Could you remind me of the geographical spread of CAS, please, just referring back to your comment on Asian customers?

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

We'll just find the geography on CAS because we have a chart just in front of us here. It's in our fact book and it's not in my head right now. But while we just take a back and find it, Ronald is going to tell you which page to find it down in a minute. We have 49%, Europe, Middle East, Latin America; Asia Pacific, 28%; and NAFTA, the smaller part, is 23%. I just checked. They do add up to 100%, which is promising.

Operator

And the next question is from Mr. Martin Roediger from Kepler Cheuvreux.

Martin Roediger - Kepler Cheuvreux, Research Division - Equity Research Analyst

Patrick, you mentioned volumes for automotive applications increased by 5%, but core volumes went down by 1.6% on limited product availability. Which kinds of products did you sell less in Africa and Eastern Europe? I guess, it's more the commodity-related product, correct? And secondly, in your interview with Reuters this morning, you mentioned more details on your intention for selling up, i.e. in Polycarbonates, reducing the business with selling product at price at EUR 1.50 per kilogram a move towards business with EUR 15 per kilogram in Polycarbonates. At which point are



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

you on your journey for selling up? In other words, how much of your Polycarbonates business is already at the high end of the value chain? And how much is in the mid low of the value chain? I would like to understand the upside potential from this product mix improvement going forward.

Markus Steilemann - Covestro Aktiengesellschaft - Chief Commercial Officer and Member of the Board of Management

Martin, if you'll allow, this is Markus speaking. I would like to, let's say, give you some flavor about what is, from our perspective, going on in the market. If you look at the polyurethanes business, I think it is important that for MDI as well as for TDI, so the isocyanate components, we were clearly seeing growth rates for first half year that were perfectly in line with the market. And here, particularly on MDI, we saw in automotive a growth rate of roughly 14%, in electric 11%, just to give you some flavor. And so that pretty much reflects how we were able to grow in specific industries quite significantly. And if we then go back where did we maybe withdraw some quantities or where did we not so much focus on core markets and so focus less on noncore applications, there is always low-end, low-value products. For example, wood binder business that is typically seen in those markets that are, let's say, noncore market, so to say, at the current point in time. So -- also here, you could see that even short term, we try to optimize our product mix towards higher-value contributing products. And I think this is what we're doing on a continuous basis and let's say, the current situation where we have limited availabilities of products.

If we look at the Polycarbonates business, you can clearly see that we have rebuilt the product mix over quite some time starting back 10 years ago when we were still having most of the sales in highly commoditized optical data storage, which, at that time, represented more than 1/3 of the market and, meanwhile, has diminished to, let's say, I would say, low to mid-single-digit percentage of the entire market. And that's why I would, today, call a significant portion. I would say maybe, it's even on par, let's say, with the commodity part. So maybe around 50% of our portfolio, we consider currently to be higher value and less volatile product as we have also communicated during our last Capital Markets Day. I hope that gives you some flavor.

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

And just to help me, Martin, on the interview this morning I have with Reuters, I've said that the price range of all Polycarbonates runs from EUR 1.50 to EUR 15 per kilogram. I wasn't suggesting that we can sell all our Polycarbonates at EUR 15 per kilogram. That would be great, but I don't think it's likely. Is that okay, Martin?

Martin Roediger - Kepler Cheuvreux, Research Division - Equity Research Analyst

Yes.

Operator

The next question is from Stephanie Bothwell from the Bank of America.

Stephanie Bothwell - BofA Merrill Lynch, Research Division - VP

Just a couple of quick follow-up questions. The first one on Polycarbonates. Just following on from the previous question. You flag in the release on the product mix improvement size and you just highlighted the remaining 50% of your portfolio is now in the higher-end part of the business. We can't obviously see that improvement in the margin because of the raw material inflation that you had over the course of the quarter. So I wonder whether or not you could, perhaps, give us a sense in terms of how margins had improved from that product mix improvement on a year-on-year basis. And the second question was on the EUR 200 million positive pricing delta that you expect in the third quarter, so not significantly different from the second quarter. So just trying to square that with your view that new supply coming to the market from both Sadara and BASF Ludwigshafen will mean you'll have lower margins in the course of the second half. So just want to get a sense in terms of your view on the timing of those 2 projects. And when I think about the EUR 200 million pricing delta, if you'll give us more of a sense in terms of how the split is between MDI and TDI, that would be helpful.

JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

Thank you for your question, Stephanie. So I'll take the first one, Markus, the second one. So the easiest way of looking at the mix improvement is that it's the bottom line worth between roughly EUR 30 million to EUR 40 million in margin. That's probably the easiest way of answering that by giving you the direct number. And then the impact of Sadara timing and our guidance on EUR 200 million price delta, Markus?

Markus Steilemann - Covestro Aktiengesellschaft - Chief Commercial Officer and Member of the Board of Management

Thanks, Patrick. Stephanie, great question. So if you look at the situation, and I have mentioned that when I was talking on Slide #8 about the PUR segment results and potential, let's say, outlook for Q3, we have actually based our assumption for the upcoming capacity that these capacities will come on time as announced. And this is already factored in into our, let's say, potential significant improvement in EBITDA for the third quarter. And from our perspective, this is a rather conservative view because we have now witnessed for more than a decade that hardly any of the announced investment, in particular on the isocyanates, be it MDI and, in particular the TDI, comes on time and in full. And just recently, there was an announcement of one larger player on TDI, for example, who announced that their expected TDI capacity will come delayed. There is now, at least to my knowledge, in the last decade, the eighth announcement that TDI capacity will not come on time or in full. So from that perspective, you can consider our models to be more on the conservative side. And that might give you some flavor about what could potentially happen if there will be any further delays, that would mean, from our perspective, that the market could stay tight for quite a while. I hope that gives you some flavor.

Ronald Koehler - Covestro Aktiengesellschaft - Head of IR

Yes, Stephanie, perhaps, if I might add. You also asked about MDI, TDI pricing delta impact. I mean, it's clear that as of Q3 last year, we saw some price increases. And obviously, we have seen significant price increases in the fourth quarter 2016. So just by this base effect, the -- let's say, pricing delta contribution from TDI is getting less already in Q3, but more significantly less in Q4. That is our base case assumption along with the idea that overall prices might come down with Sadara. And that might be conservative for the fourth quarter. On the other side, we always highlighted that MDI is our structural, let's say, improving part. And we'll stay confident that this is the case that we can deliver longer for stronger here or stronger for longer results. And clearly, we do not see any kind of later impact. On the contrary, we actually see, despite already that Sadara is shipping materials, we see that our customers are actually still angry with us if we are not able to deliver everything. So the market seems to be short despite first deliveries from Sadara.

Operator

(Operator Instructions) And the next question comes from Mr. Thomas Wrigglesworth from Citi.

Andrew Benson - Citigroup Inc, Research Division - MD

It's actually Andrew Benson. Just wondering on the polyols business, where we've seen Lyondell recently go ahead with a pretty substantial propylene oxide investment on its own rather than turning it of the joint ventures you've had. Can you just sort of give us an update on your thinking on how you're planning to expand capacity given that's one of the areas where you're being constrained for some time?

Markus Steilemann - Covestro Aktiengesellschaft - Chief Commercial Officer and Member of the Board of Management

Andrew, good to talk to you again. Well, we, for sure, have made no secret out of the fact that we are somehow limited on the polyol's growth. But also here, it is quite important that we have opportunities to sell up here. That means to upgrade our portfolio and generate maximum value out of this portfolio that we have in the polyols area. And yes, we also have heard about these investments planned for some players. And we're looking, let's say, also here from an overall market perspective that those investments are absolutely necessary to fulfill also the growing demand of polyols



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

in our markets also to support the overall polyurethane's growth in the different applications. So from that perspective, very much welcome what is going on here in the market. Does that give you some flavor?

Andrew Benson - *Citigroup Inc, Research Division - MD*

Well, it doesn't say what you're doing. I just wonder how your plans are evolving.

Markus Steilemann - *Covestro Aktiengesellschaft - Chief Commercial Officer and Member of the Board of Management*

Well, we have still some opportunities to de-bottleneck some of our plants and get a little bit more volume. But overall, we have to say that our growth opportunities, let's say, short to midterm are somewhat limited. However, we have addressed these topics and are working here on the long-term growth opportunity.

Operator

The next question comes from Mr. Paul Walsh from Morgan Stanley.

Paul Walsh - *Morgan Stanley, Research Division - MD*

Two questions for me. First question is just around the cash flow. I just want to make sure there are no sort of exceptional items we should think about impacting cash in the second half of the year, probably beyond what you've said around bonus payment accruals and working capital and so on. No other cash out is expected in the second half beyond that? That's my first question. My second question is just around the dividend, really. You made it clear at the Capital Markets Day what the sort of capital allocation policy was over the next 24 months. But you're going to deliver, I don't know, somewhere around EUR 2.8 billion, EUR 2.9 billion in EBITDA this year flowing that down through the earnings level. Just wondering how you're feeling about just the regular ongoing dividend payment because I know you talked about going below the sort initial threshold on payout ratio. But clearly, the earnings numbers for this year, at least, is going to be much higher than the previously anticipated.

Ronald Koehler - *Covestro Aktiengesellschaft - Head of IR*

Okay. On your cash flow questions. No, there shouldn't be any special thing in the second half year. As you rightly pointed out, we had our bonus payouts mainly in the second quarter. We had a bit of that actually already in the first quarter. But this is gone. We're obviously building provisions for the ongoing bonus program already since the beginning of the year, again, for next year. But on a net-net basis, that will clearly increase provisions for bonuses in the second half year, so that would be positive cash contribution. On the other side, we clearly have the typical CapEx saving, which means we have just EUR 166 million spend so far. We reiterate our guidance of EUR 550 million for the full year. So there is a typical ramp-up with the majority of spending in the fourth quarter. And last not least, we have -- on the cash side, we hardly paid any taxes in the first half year with around 5% cash out and that should normalize to 28%. So here is also a higher cash burden in the second half from the cash tax payments. Working capital on the other side, was very high end on Q2. There might be a bit of relief depending obviously on raw material price development and overall pricing development. But that, let's say, might have peaked and these are the components you might consider for the cash flow.

Paul Walsh - *Morgan Stanley, Research Division - MD*

Very clear. And just on the dividend?



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

And from a dividend point of view, I think we're clear as well on our policy. So we have the 2016 base year as our marker. And from there, we would intend to maintain or increase that dividend. When we get to the end of the year, we will enter into a debate with our supervisory board about dividend payments. And we should follow our policy as we have highlighted it. So steady to increasing depending upon the performance, but never going backwards was our promise, I think, if I remember right. And I would like to stick with that, if I can. Is that okay, Paul?

Paul Walsh - Morgan Stanley, Research Division - MD

Yes. No problem, Patrick.

Operator

The next question comes from Mr. Geoff Haire from UBS.

Geoffrey Haire - UBS Investment Bank, Research Division - MD and Equity Research Analyst

Just wanted to follow up on the comments you made in terms of the outlook for the second half around core volumes going to low to mid-single digits. Can you just talk a little bit about what sort of you're seeing in your order books already for the second half to confirm where -- is that what you're expecting? And what's happening in end markets?

Markus Steilemann - Covestro Aktiengesellschaft - Chief Commercial Officer and Member of the Board of Management

Geoff, what is quite important is that we currently see that market demands is very healthy and that goes across all industries in all the applications where we are present. And we here can strongly rely on our global footprint. So we have a fairly good view, actually, on what is going on across the globe, across regions and what we can see from different applications. We currently, if I may say so, live from hands to mouth or maybe, our customers feel as if they live from hand to mouth because everything we get out of the plant, we ship immediately. So every drop is squeezed out. Everything is delivered immediately to the customer, unless we need it, for example, to build up, let's say, inventories for shutdowns that are planned. But other than that, demand is extremely healthy, I would say. And therefore, for third quarter, we are very, let's say, much having an insight about what's going on. Just consider that, in first quarter alone, MDI was growing at a rate of 7%, which is quite above what you would say on a long, let's say, mid- to long-term average. And for Polycarbonates, we currently also see that the industry demand in the first quarter was between 11% and 12%. That might give you a flavor of where we are currently at and that we really ship out everything we have. And we currently do not foresee any signs in the market that this will change.

Operator

And the next question comes from Mr. Laurence Alexander from Jefferies.

Jeffrey Schnell - Jefferies LLC, Research Division - Equity Associate

This is Jeff Schnell on for Lawrence. Have you seen any change or slowdown in the auto lightweighting trend in more saturated markets, like the U.S. and Germany or at least, has it started to get a little more difficult? And second, follow-up on a prior question in Polycarbonates, could you highlight any regional trends in demand? That is, are there any regions that are getting particularly stronger or weaker than others?



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

So maybe I'll answer the question on automotive and Markus will answer the question around your second point. Yes, lightweighting is very interesting and we've been doing a study recently on lightweighting. So conventional cars, of course, already use polyurethanes and polycarbonates. And we estimate that an electric vehicle, fully electric, will use about 3x the amount of material that we currently use in a car. For example, a typical conventional car uses about 8 kilograms of polycarbonates. The Tesla Model 3 uses about 15 kilograms. And then BMW i3 uses about 30 kilograms, excluding the battery housing, which is the charging station, which is another 8 kilograms. So as mobility goes beyond e-mobility and towards autonomous driving, we think that there's a couple of trends that are very relevant and favor our materials and will drive this lightweighting growth even further. The interior for autonomous vehicles is all about what they call the mobile living room and large touchscreens, large windows, clever lighting systems, illumination. And of course, an economic mass and safe mass production of the battery modules is very important. And the typical car battery uses the same material that's used on power bricks or laptops and PCs, things like that. So that's the interior. Exterior, there has to be what's called Car-to-X communication, which is how the car communicates to other cars and to people outside the vehicle. That's all display technology integrated into surfaces, radar systems, UV lights, antennas, all needing a good class-A surface. And that's where Polycarbonates comes into play. It's enormous. And of course, not forgetting the infrastructure. Every time a charging station goes in, that's about 8 kilograms of Polycarbonates. And that's growing at around about 150% at the moment last year in China alone. So this trend is absolutely stable. I think the way to look at it is with conventional cars, we've seen the efficiency drive on the engines using all sorts of technologies and they've really reached the end of what is possible with that sort of technology. Now it's all about how do you provide the same level of comfort and trim, but with much lower weight. And that's where our materials really do kick in. And we see strong development in this zone. This is what's driving a lot of our Polycarbonates business growth. So Markus?

Markus Steilemann - Covestro Aktiengesellschaft - Chief Commercial Officer and Member of the Board of Management

Yes. Also from my side to add some color on what do we see for Polycarbonates, I think it is, first, important to state that what you see as the regional picture is the sum of the parts of the application. So it's not necessarily predominantly a regional effect. But primarily, it is an application effect. So the application mix determines normally how a region develops. If we look into this, first and foremost, let me give you an idea about what happens in automotive. Automotive, first half of the year, we see something like 3% growth for global demand and light passenger vehicles up to 6 tons. If you translate that into our sales, we saw 8% volume growth on a global basis. And this is in all regions, quite strong growth. We have automotive in Asia Pacific, in Europe as well as in North America. If you now look at the different numbers, you can see clearly say that polycarbonates grew at the slowest pace in Europe, then followed by significantly higher growth in Asia Pacific. Let's say, top notch for the first half of the year was clearly North America. And this was also driven by electro electronics, where we have very strong sales in Asia Pacific, but also the very strong demand for Polycarbonates and significantly higher than in any other region in automotive. That means what Patrick just explained. The lightweight trend still continues. People start not only to replace metal, but they also start to replace other polymers in cars, with Polycarbonates because of the unique combination of properties. Single properties of Polycarbonates can always be outpaced by single, let's say, other materials, but the combination is what drives modern cars and what drives the significantly above market demand for Polycarbonates also in our business.

Operator

The next question comes from Mr. Thomas Swoboda from Societe Generale.

Thomas Swoboda - Societe Generale Cross Asset Research - Research Analyst

I have smaller questions all around your currency exposure. I just noticed your guidance is still based on euro-U.S. dollar of \$1.10. We are currently at \$1.16. We haven't talked much about currencies since you were IPO-ed. So I'm just wondering if you could give us an update on your U.S. dollar exposure. Eventually, you have U.S. dollar sensitivity you could share with us. What should we consider looking at your currency exposure? Do you have any hedges? Do you have a significant natural hedge? Anything that could help us assessing your currency exposure will be helpful.



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

Thanks for your question, Thomas. And I see that you've now taken over amongst the analysts from Ronald as asking the most difficult and penetrating questions on currency. So I'm going to pass this one to Ronald to answer because he is our currency guru. So if he doesn't give you a complete answer, I don't know who can. Ronald?

Ronald Koehler - Covestro Aktiengesellschaft - Head of IR

That's now up for a challenge, yes. The point #1, we clearly highlighted historically that we have mainly translation effects, which is still true. This means actually, at the end of the day, we'll produce always typically where we sell the product, especially in North America and especially in China. And on the dollar sensitivity there is a translation sensitivity of 1%. Change affects EBITDA by around EUR 12 million on a full year basis. You're right to spot that our guidance is based on \$1.10 as average rate. So that's obviously the first point. I mean, we are now at \$1.16, but we were obviously below \$1.10 in the beginning of the year, so it might still average out. On the other side, be assured, the currency can also move and we still stick to this significantly up. I think we shouldn't have any problems with that based on currencies. And as I said, only transition was EUR 12 million. To make the picture a bit more complete, as the renminbi also moves along with the dollar, 1 percentage point changes in renminbi makes that roughly EUR 7 million on a full year basis in EBITDA. Yes, and that's also covered in our guidance.

Operator

And the next question comes from Chetan Udeshi from JPMorgan.

Martin Evans - JP Morgan Chase & Co, Research Division - Head of the European Chemicals Equity Research

It's Martin Evans, actually. Just a quick question back on pricing in the third quarter and your confidence thereon. Just in terms of Asian prices, which have been, as I'm sure you know, very, very strong in the last month or so, up some 20% to 30% in TDI, in particular. Is there any particular reason for that? Any elements of sort of restocking again after the fall off in the second quarter? And any sort of particular Asian issues that we should be aware of?

Patrick Thomas - Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO

So on TDI, Martin, it's an interesting picture for me because if you look at the ISIS data, which you probably have access to, you'll see that the general long-term trend on TDI in Europe and in North America is upward on a pretty slow and steady dynamic. And that reflects the global tightness. What you then see is a much more volatile picture in Asia. And that is caused partly because there are more producers in Asia. There are only 2 in America, 3 in Europe and the majority of the others are in Asia. But there's more of a competitive battlefield in Asia, if that's the right way of putting it for pricing. And the other unique feature of Asia is there are traders. And those traders are jumping in and out of the market and trying to use this volatility to create value. And by and large, they succeed. So as a consequence of that, you always see this big difference between the Asian trading position on TDI and the rest of the world. What I would underline is -- and you've seen this shop pick up in the last week or so, on TDI pricing again. The TDI prices at the end of July in Asia are actually below America or Europe. So what we've seen is a position where the initial fly up was well above the rest of the global prices. They then dropped below U.S. prices, stayed there for a while. And now they dropped below even European prices. So really, those showed that the battlefield on TDI, which is traded by commodity. It's 10% of our total business. Not a big deal. It's very profitable across the cycle. But you do get these very different regional dynamics because of the number of competitors and because of the presence of traders, particularly in Asia. I hope that's helpful, Martin.

Operator

And the next question is from Mr. Patrick Lambert from Raymond James.



JULY 25, 2017 / 1:00PM, 1COV.DE - Q2 2017 Covestro AG Earnings Call

Patrick Lambert - *Raymond James Euro Equities - Research Analyst*

Just a few follow-up. Again, on automotive, I just want to confirm that you said that the demand for you guys on automotive application was about 8% in H1. How much was it in Q1 and Q2, the development of the growth there? And then if you could comment on the beginning of Q3, how July look like for automotive? That's one. And second, on Sadara, at the Capital Markets Day you mentioned that the products at Sadara, at least what you've seen of the products at Sadara, was going to lower applications and mostly in emerging countries. Is that still the case? Or have they ramped up the quality of products?

Patrick Thomas - *Covestro Aktiengesellschaft - Chairman of Board of Management, CEO & Interim CFO*

Okay. Very good, Patrick. Yes, your question about automotive, if I've got it right, Q1, Q2, the split was 12% and 5%, giving 8% in the first half year. Our view on Q3, Markus, do you have a feeling as to where automotive is going at the moment?

Markus Steilemann - *Covestro Aktiengesellschaft - Chief Commercial Officer and Member of the Board of Management*

As I said earlier, we do currently not see any, let's say, slowdown in demand for the applications where our product go. If you compare the numbers that you have seen in Q2 and Q1, we have to figure in that, in particular in Polycarbonates, we ramped up our production capacity in second quarter of last year. And that's why we really compare the second quarter numbers to a very strong second quarter in 2016. So what you see here in our growth rate is not at all indicative for the overall demand, for example, that you would conclude is slowing down. We see exactly the opposite demand for our material across the board, across the applications in automotive is very, very strong. So now on your second part on Sadara, it goes into the low-end applications. That's what we told during the Capital Markets Day. And currently, we have no indication that there's significant amount of this material showing up in any other market. So the picture that we have drawn on the Capital Markets Day on where the material from our perspective is going to has not changed.

Operator

Mr. Koehler, there are no further questions at this time. Please continue with any other points you wish to raise.

Ronald Koehler - *Covestro Aktiengesellschaft - Head of IR*

Good. Thank you all for listening and for your interesting questions. If you have any follow-up questions, don't hesitate to call the IR department and otherwise, we will speak to you later on the Q3 results then. Thank you. Bye.

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