Ladies and gentlemen, thank you for standing by. Welcome to the Covestro Earnings Call on the Q1 2021 results. The company is represented by Dr. Markus Steilemann, CEO; Dr. Thomas Toepfer, CFO; and Ronald Koehler, Investor Relations. (Operator Instructions)

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

Ronald Koehler Covestro AG - Head of IR

Yes. Thank you. Welcome from my side to our Q1 2021 Conference Call. And just for housekeeping, we have the interim statement and the investor relations presentation at our web page. And I assume you have read our safe harbor statement. And with that, I already turn over to Markus.

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Thank you very much, Ronald, and very good morning. Good day and good afternoon to everyone on the call. As you can see from Slide #2, our financial highlights for the first quarter 2021. The first quarter 2021 performance was well above previous year's level. Also, the first quarter 2021 performance was well above pre-pandemic levels of 2019. The trend of dynamic demand recovery and increasing product margins started in the second half of 2020 is continuing.

Now let's turn to Page #4. The core volumes, as I mentioned before, increased by 5.3%. Prior year basis was already impacted by the coronavirus pandemic, especially in Asia Pacific. The current quarter is burdened by unplanned outages, mid-single-digit percentage reduction of global core volumes in Q1.

This trend is also continuing for the first half of 2021. In total, the Q1 core volumes were 5.3% above previous year levels. EBITDA came in at EUR 743 million, in line with our Q1 guidance of EUR 700 million to EUR 780 million and as preannounced on April 13. We saw very strong free operating cash flow of EUR 318 million. The RFM acquisition was closed on April 1. And on closing day, we welcomed 1,800 highly motivated new colleagues. We raised our earnings guidance for full year 2021 as announced on April 13, and we see various short- and long-term trends that are partly opposing each other. This leads to a rather low visibility.

Now let's turn to Page #3. The core volumes, as I mentioned before, increased by 5.3%. Prior year basis was already impacted by the coronavirus pandemic, especially in Asia Pacific. The current quarter is burdened by unplanned outages, mid-single-digit percentage reduction of global core volumes in Q1.

If you now look a little bit deeper into the regions. On low comparable figures, the volume rebound compared to prior year of 27.3% in APAC is very high. For another perspective, volume growth of 6% versus the first quarter of 2019, so pre-pandemic. China was clear driver and the demand rebound pushes volume growth in all key industries to rates of 50% to 80% year-on-year versus the low previous year basis.

We had a solid underlying demand in Europe, actual volume growth was limited by constrained polyols availability. We also saw strong underlying demand in North America. Declining volumes were just the result of constrained availability in all product groups after the
U.S. winter storm Uri.

Now let's turn the picture to an analysis by industries. The ranking is done by kilotons sold to specific industries. Furniture, we saw a mixed picture. Overall, a small decline, yet Asia Pacific 28% (corrected by company after the call) up year-on-year. On construction, up 3% year-on-year globally, driven by good demand in the Europe, Middle East, Latin America region as well as Asia Pacific region, and we saw a decline year-on-year in North America due to limited availability, mainly of MDI and polyols.

In automotive and transportation, plus 14% year-on-year globally, again, driven by Asia Pacific and slightly better than global auto production. On medical, in diverse industries, small business but continued dynamic growth of 13% year-on-year.

Now let's turn to Page #4. Longer-term quarterly comparison underscores: the performance is not only above previous year, but also above pre-pandemic levels of 2019. The first quarter 2021 sales were up plus 4.2% and volumes plus 1.0% compared to pre-pandemic levels of the first quarter 2019. The year-on-year top line comparisons benefit from low comparable figures in the first quarter 2020, impacted, as mentioned earlier, by the pandemic.

Operationally, we saw increasing earnings momentum that started in the second half of 2020 continued into the first half of 2021. Improving industry trading at the same time and industry trading conditions as well as industry margins allowed to increase selling prices over feedstock prices, especially in PUR. Compared to the first quarter 2020, EBITDA strongly benefited from positive pricing delta as well as from higher volumes, compensating provisions for variable compensation that increased accordingly.

We delivered 22.5 percentage point in margin in the first quarter of 2021, and this is the highest EBITDA margin for 10 quarters. But still well below historic margin peak of 21.8% in the first quarter 2018.

Now let's turn into other segments and turn to Page #5, we start with polyurethanes. Core volume growth was only 2.5% year-on-year despite solid underlying demand. We continue to be sold out. Of all segments, PUR are most burdened by the constrained availability after the U.S. winter storm Uri. Higher prices year-on-year drove sales up 36.1% and positive pricing delta contributed vast majority of year-on-year EBITDA growth, compensating higher provisions for variable compensation.

Some remarks on the trading environment. The current demand is outstripping our ability to deliver. Based on anecdotal evidence, finished goods inventories seem very low in value chain, especially North America and partly in Europe. The global prices continue to move up in North America and partly in Europe, but declining in Asia Pacific. Overall, we assumed slightly declining prices during the second quarter.

Based on IHS data, current outage rate expected to decline during second quarter or latest in the third quarter. Let me give you a few examples. First example, on MDI global outage rate, we assume it is currently around 20% in the first quarter, and that is expected to decline to around 15% in the second quarter and 10% in the third quarter. On TDI, the global outage rate is around 15% in the first quarter, expected to be around 20% in the second quarter, but decline to around 10% in the third quarter. Future unplanned outages are, for sure, not considered.

Now let's turn to polycarbonates on Page #6. The core volume growth was plus 11.6% year-on-year, profiting from dynamic demand recovery in Asia Pacific, comparing also to a low prior year basis. The double-digit volume growth in automotive, transport, electro globally, leading to improving product mix and more sales in specialty high-margin rates. Higher prices year-on-year and higher volumes equally drove sales growth.

Positive pricing delta also drove year-on-year EBITDA growth, compensating higher provisions for variable compensation. The EBITDA margin of 25.0% in the first quarter is still well below historic peak of 30.3% in the third quarter of 2018. Also here, I would like to give you some remarks on the trading environment.

Commodity pricing reflects favorable competitive environment. Significant capacities of non-backward integrated polycarbonate producers in China remain offline due to Bisphenol A shortage, likely well into the year 2022. Announced capacity additions in China in
2021 expected to arrive, exact timing and scope, however, of available capacity is still unclear. The expected normalization of prices mainly relates to commodity/general purpose grades, which represent around 50% of our sales.

We see further scope for mix improvements given the expected production increases in automotive in the second half of this year, rollout of 5G technologies and further market share gains in specialties and the steady launch of innovative products.

Now let's turn pages to Coatings Adhesives Specialties. We saw for the business unit CAS strong volume growth of 7.1% year-on-year, driven by all key industries. This was also true for double-digit growth in furniture and wood applications. Regionally, the most dynamic region was not as a surprise, the region Asia Pacific. Higher volumes year-on-year drove sales growth. Volume leverage was above group average and translated into positive effect for the EBITDA. However, overall EBITDA decreased 12.3% year-on-year mainly due to the higher provisions for variable compensation linked to strong group performance.

These burdened particularly employee-intense CAS segment more than proportionately. The integration of the acquired RFM business is running at full steam since the closing date on April 1. Investment in high-growth downstream business continues and expansion of PC specialty film production in Dormagen, Germany was just announced last week.

Now I would like to hand over to Thomas.

Thomas Toepfer
Covestro AG - CFO, Labor Director & Member of Management Board

Yes. Thank you, Markus, and also a very warm welcome from my side. I'm on Page 8 of the presentation, and you see the sales bridge. Now our sales in Q1 increased 18.8% year-on-year, and that was driven by sales growth in all 3 segments. Let me go into the bridge. If you see the volume effect, that EUR 94 million, you will note there's a difference between the volume effect in euros, which is 3.4%; and the core volume growth, which we posted in kilotons of 5.3%, and the reason are declining noncore volumes and the negative product mix effect that we had to digest in Q1.

Obviously, the largest sales driver is the price effect, EUR 563 million or 20.2%. And there was a negative FX effect of minus 4.8%, and that is reflecting the weakness of the U.S. dollar, the Chinese renminbi, the Brazilian real, the Mexican peso, also the Indian rupee relative to the euro.

So let's quickly move to the next page, the EBITDA bridge. As you can see, EBITDA almost tripled compared to Q1 of last year, and we achieved EUR 743 million, fully in line with the guidance that we had given out. So the volume leverage is limited to 39%. That is a EUR 37 million absolute number that you see in the bridge due to the unfavorable product and regional mix effect, and the pricing delta of a positive EUR 560 million obviously is the key driver, and the large majority within the price effect was contributed by our PUR segment.

And then you see in the bridge, the other items bucket and that includes 2 major effects. First of all, a negative EUR 105 million impact from higher provisions for variable compensation. And secondly, for the first time, we included EUR 16 million negative onetime effects related to our LEAP transformation program. And then, of course, cost savings worked against those 2 so that it came out at the EUR 85 million that you see in the bridge.

In terms of the constrained availability after the U.S. winter storm Uri, I can tell you that we had a mid-double-digit euro million impact on the earnings, and that includes both the lost business and also the extra expenses to restore the facilities.

Let's move to Page 10, where you have the cash flow statement. As you can see, our free operating cash flow improved by almost EUR 600 million year-over-year. And the free operating cash flow thereby achieved EUR 318 million driven by significantly higher earnings, and you see this in the little table below the chart.

What you also have is the effect of the working capital, which is negative. And the working capital sales ratio came in at 21.1%. I would say that this is very much a mathematical effect because we are comparing a quarter and working capital which is based on very high prices relative to a 12-month sales run rate, which includes, of course, a very weak Q2 2020. And therefore, we do expect that the ratio
will come back to the usual corridor of 15% to 17% in a more normal year.

What I would also say in terms of working capital, it’s clear that inventories, if you measure them in euros, increased in our cash flow statement by EUR 230 million, so an increase relative to the December level. But if you compare them year-over-year in kilotons, they are down by about 7%. So that just gives you an impression that we are still sitting on a relatively low inventory level.

Then you have the CapEx, also in the middle table, we spent EUR 110 million, which is fully on budget and also absolutely in line with our full year guidance for 2021. You see that we paid income tax of EUR 50 million, which, of course, is driven by some time lag because the tax authorities usually use the prior year quarter earnings to determine the tax prepayments, and that will have an effect for the entire year of 2021. And therefore, the expected cash tax rate will be somewhat below the P&L tax rate, which we have guided to be between 24% and 26%.

And then last but not least, you have on the table the other effects that reflects higher provisions for variable compensation. So we are building provisions every quarter in our EBITDA. However, the cash out for the bonus will only occur in the second quarter of 2022 for the full year of 2021. So the expected EBITDA impact year-over-year of this provision is roughly EUR 400 million. And then, of course, will be reversed in the cash flow statement because, as I said, the cash flow will only be impacted then in 2022.

So with that, let’s turn the page to Page 11 and look at the balance sheet. We did have a very strong balance sheet as of March 31, with a very high cash position of EUR 2.8 billion reflecting, of course, the preparation to close the RFM acquisition. And we closed then the deal on April 1 with an enterprise value of EUR 1.55 billion. And because of that specific situation, the ratios, of course, look particularly strong. For example, the ratio of total net debt-to-EBITDA was only at 0.95x versus 1.9x a year ago.

And there’s one more change where I would like to draw your attention to, that is our pensions, which are EUR 348 million lower relative to the December level, simply because of higher discount rates, especially in Germany. One thing is unchanged, and that is our commitment to have a solid investment-grade rating. And Moody’s just recently changed their rating from a Baa2 with a negative outlook to a Baa2 with a stable outlook, which we, of course, very much appreciate it.

So with that, let’s look at Page 12. We did raise our EBITDA guidance to the corridor of EUR 2.2 billion to EUR 2.7 billion on April 13, and the key reason for the upgrade is the better than originally expected margin development in the first half of 2021, and as a consequence, also a higher starting point for the second half of this year.

I think what you can also see in the chart is the mark-to-market estimate currently stands at EUR 3.1 billion for the full year. So that is if you use the March market data and take the midpoint of the guidance range for the core volume growth, so the 6.5% organic growth.

So now why do we assume that prices and margins will come down starting in early the second half of the year? First of all, the overall industry utilization rates are still rather low based on nameplate capacity and the underlying demand. And secondly, if prices started to go down, it might be quick and sharp, and such a scenario is covered by the low point of our guidance.

So the guidance is including the announced RFM acquisition. However, as we said before, the RFM net earnings contribution is expected to be neutral or even slightly negative, because the integration costs are compensating or even overcompensating the EBITDA contribution. And also the inventory step-up will have a negative effect. And we have given you the volume and also currency sensitivities, which are unchanged in the little box right to the chart.

So with that, let’s go to Page 13, where you have the guidance overview. I think the key message of the chart is that, in 2021, we expect to exceed the pre-pandemic level of 2019. We do confirm the raised earnings outlook for 2021 as we have published it on April 13. And I would like to remind you that the guidance includes RFM, but it excludes potential further LEAP onetime effects.

So let’s just have a look into the line items. The core volume growth of 10% to 15% is unchanged, and that includes 6 percentage points from RFM. I would say that the midpoint of organic growth rate of 6.5% is absolutely still realistic. However, the upper end of 9% organic growth becomes a little ambitious due to the unplanned outages, which we had in Q1 and which will also affect Q2 given our low
inventory levels.

The EBITDA forecast incorporates the effects related to the provisions for the variable compensation. So as I said, roughly EUR 400 million more year-on-year, and that is reflected in the guidance midpoint for 2021. And in terms of the cash flow, they will only be paid out in 2022, and therefore, they will only affect our free operating cash flow in 2022, as I said.

So if we look at the second quarter of the year, we're expecting that sequentially, the volumes will be slightly higher in Q2 versus Q1, so versus the 1,263 kilotons, which then translates into a growth rate of more than 25% if you compare it to the previous year. So that for Q2, again, we're expecting an EBITDA of between EUR 730 million and EUR 870 million driven by slightly higher volumes and the relative stable margin and also fix costs.

What I would also say with respect to Q2 that it also includes a low- to mid-double-digit million burden from the U.S. winter storm, Uri, together with the Q1 effect that brings us to a total negative effect to mid- to high double-digit million euro amount. As I said, this is fully incorporated both in the Q2 guidance and also in the full year guidance in terms of EBITDA.

And with that, I would like to hand it back to Markus for the highlights and also the closing.

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Yes. Thank you very much, Thomas. So on the first quarter highlights, the operational as well as financial performance is well above the pre-pandemic levels of 2019. So let me go line item by line item.

The volume growth reflects strong demand rebound, however, as we have outlined earlier, that was limited by constrained product availability. We have seen that the EBITDA tripled due to positive pricing delta, and we see continued momentum into the second quarter of 2021. That also came along with a strong cash performance, which is based on strong earnings as well as positive cash phasing effects.

We raised also, therefore, in April 13, our earnings outlook and that is what we, today, once again confirm, and we are now with that above mid-cycle levels. And last but not least, the transformation program, LEAP, is well on track and we plan to implement a new organizational setup as of 1st July 2021, including the acquired RFM business.

With that, I would like to thank you. And now the entire team is available for your questions. Thank you very much.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question comes from Christian Faitz, Kepler Cheuvreux.

Christian Faitz Kepler Cheuvreux, Research Division - Equity Analyst

I have one question, please. It's on CAS. Can you please explain the volume weakness in CAS in Europe? Is this largely car industry related? And also, maybe in that context, given the semi supply shortage in the car industry, Markus, you alluded to that a little bit already. You can confirm that we do see pent-up demand from automotive in the second half of this year, right?

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Yes. Christian, thanks for your question. If we look at the, as you call it, volume weakness of CAS in Europe, that was referring back to a Leverkusen plant force majeure that we had. And here, particularly to give you a little bit more detail, we are cooling down some of the resulting product mix to a very low temperature. So we're talking about minus 30 to minus 40 degrees.

And one of the external third-party providers of this cooling device actually had to declare a technical failure, and that's why we could only operate at very limited rates that has lowered our yield and it also has, therefore, lowered the output of final products. And that was the main reason for the, as you call it, volume weakness in Europe. So if you want to say it's a force majeure. Demand was very healthy in
this context, and we really struggled to fulfill all customer orders here. And we see also that the demand has continued to be very good in this area. I hope that answers your question.

Operator
And the next question comes from Geoff Haire, UBS.

Geoffrey Haire UBS Investment Bank, Research Division - MD and Equity Research Analyst
This is Geoff Haire from UBS. I just wanted to ask if you could just give a little bit of more detail around the margins that you're seeing or product margins you're seeing, particularly in polyurethanes in the different regions because it would appear that there's quite a big spread between them in each of the regions. Just wondering if you could give some more details.

Markus Steilemann Covestro AG - CEO & Chairman of Management Board
Geoff, this is Markus speaking. Thanks for your question. Let me start with PUR. If you look at PUR, we see that still despite the recent movements we have seen according to some market reports on prices, still the highest prices we see in Asia today, and they are currently coming slightly down, but they're still not yet at the level that we see on the margin and pricing levels in Europe.

And the U.S. level is currently slightly below the average, but is improving. So we have kind of a slightly different picture than you would actually have expected in previous years, where normally the U.S. was the high-margin regions, whereas normally Asia Pacific was the region where we had seen margins below average. So highest in Asia slightly, but just slightly coming down, EU on average and the U.S. come slightly below average, but improving.

Operator
The next question comes from Markus Mayer, Baader Bank.

So we come to the next question, it comes from Thomas Swoboda from Societe Generale.

Thomas Swoboda Societe Generale Cross Asset Research - Research Analyst
I have 2, if I may. I would try to ask you about the guidance. I appreciate the visibility is low, so it's very difficult. But looking at the low end of the guidance range, which you stress in your prepared remarks, that would mean that Q3, Q4 would be at a run rate of EUR 300 million, EUR 340 million EBITDA. Do you assume in this scenario that earnings undershoot in the second half as they do overshoot right now? Or is the EUR 300 million to EUR 350 million a level where you think that could be sustainable given the current supply-demand situation?

And the second question, hopefully a little bit easier. In CAS, I understand you had this plant problem. But is there an element of input cost increases, which you not manage passing through quick enough in the CAS result? And the bigger question here is how long does it take you to pass through input cost increases? So when will be able to see a kind of a normalized profitability in CAS?

Thomas Toepfer Covestro AG - CFO, Labor Director & Member of Management Board
Yes. Thomas, this is Thomas. Let me take your first question. And thanks for qualifying it as a little bit more difficult. So I would say we do have currently very constructive margin levels. And we've seen that this has continued from Q1 fully into April, and also as we look into May, the momentum stays very, very stable and positive. June visibility starts to get a little bit more fuzzy, and we have less visibility into the second half of the year. So by nature, we just want to be cautious, and that is also reflected in our guidance overall.

As you characterized it, I would say the low end of the guidance really implies that there is a very sharp and rapid correction of the margin level. And let me reiterate, we have no indication at this point. But of course, we also have reflected this case in the guidance. And that would then mean, as you correctly said that, in our view, the prices and margins would undershoot, so they would be at a level that is clearly below mid-cycle. And this is how I would characterize the guidance that we've given out.
Markus Steilemann  Covestro AG - CEO & Chairman of Management Board

Thomas, this is Markus speaking. On the second question. If you look at the Coatings, Adhesives, Specialties business on top of the effects that we have already mentioned, we have Leverkusen force majeure, we had also due to the winter storm, Uri, force majeure for operations in Baytown, including the CAS operations. And that was the major effect, I would say. The input costs were up, you're right, but they could be still covered as of today with increased prices. And there might be still slightly negative effects coming from that and also from the force majeure continuing into the second quarter. But these are effects where we would assume that they would, in the course of the year, also disappear.

Operator

The next question comes from Charlie Webb, Morgan Stanley.

Charles Webb  Morgan Stanley, Research Division - Equity Analyst

Maybe just 1 around outage issues and force majeure. Could you just update us on current situation for Covestro as it relates to force majeure? Do you have any lingering issues kind of coming from the deep freeze? Or is that all now resolved? Just trying to understand that mid-double-digit impact you see in Q1 and if there's anything kind of lingering into Q2 that will curtail volumes?

And then second question, I know it's very early, perhaps in terms of the integration of RFM. But any kind of update how that business is trading thus far this year? Anything surprised to you? And are you still confident in the synergy delivery?

Markus Steilemann  Covestro AG - CEO & Chairman of Management Board

Yes. Thanks, Charlie, for the question. I will take the first one, Thomas then will give you the trading update on RFM. The situation in the United States is, in Baytown, that we're still all under force majeure in all 3 product groups. And the inventories, given the very challenging situation for us as well as for our customers and suppliers, are still very low. And therefore, we assume that the force majeure still might stay in Q2. And some, just let me emphasize this, some might be even carry into the third quarter.

Because we have to do really some repair work on our plants, but also something is very important. We're talking here about an entire supply chain effect. That means not only us, but also our suppliers are affected. And if you think about the massive repair works that needs to be done almost in the entire region, you might understand that we are slowly and steadily recovering, but that we are still recovering, and that's why we're still under force majeure.

With that, I would like to hand over to Thomas.

Thomas Toepfer  Covestro AG - CFO, Labor Director & Member of Management Board

Yes, Charlie, with respect to RFM, I can tell you, we're seeing very good demand. And in terms of the numbers and the business -- I mean the as-is numbers for 2020 but also then the outlook for 2021. I would characterize this as slightly better than what we had expected in our due diligence business case. So therefore, no surprise, if any, on the positive side. And in terms of the closing and also the welcoming of the 1,800 new employees, I would say this went extremely smooth.

So we do think that this is a great fit not only from the business perspective, but also from the cultural perspective. And therefore, I would say the -- what we experienced in terms of openness and in terms of collaboration is absolutely great. And therefore, I would say, very good start into the integration process, which will take place over the course of the year.

Charles Webb  Morgan Stanley, Research Division - Equity Analyst

That's very helpful. Maybe just one really quick follow-up on the first point around the force majeures. Am I right in thinking that when we kind of talked about the U.S. prices lagging Rest of the World, much of that we can kind of put down to force majeure as in you can't really increase prices if you're under force majeure conditions. And therefore, that is why the pricing is lagging a little bit in the U.S. Is that fair?
Markus Steilemann  
*Covestro AG - CEO & Chairman of Management Board*

Well, first and foremost, I think the United States market in general, and that is a long-term experience that we have observed over many years, the price environment is anyhow less volatile. And that is, I think, significantly different to, for example, the markets in the Middle East but also the markets in Asia Pacific. And also partly that is due to the situation that you have described, the force majeure situation.

So there, we have at least strictly limited opportunities. It's not totally excluded on the specific circumstances, take pricing formulas and things like that. But if you don't have any pricing formula in place, there is limited opportunities. So there's partially also the suggestion that you made the reason for that.

Operator

And the next question comes from Georgina Iwamoto, Goldman Sachs.

Georgina Iwamoto  
*Goldman Sachs Group, Inc., Research Division - Associate*

My first question is regarding capital allocation. It looks like there’s a fairly good chance Covestro is going to be net cash even by the end of this year. Exiting the year in a mid-cycle environment net cash is pretty unusual. But with that in mind, just wondering if you could maybe talk about how you would see the U.S. MDI project at this point in time. And I was particularly wondering how that fits in with Covestro's shift in strategy to become fully circular. How long ago was that project first kind of drawn up? And does the dynamics of that project fit in with Covestro's new strategy?

And then my second question is for a clarification on the bonus provisions. Just exactly how much has been factored into the guidance? Because if I look at the bonus kind of provisions within the mark-to-market and also your cash guidance, it looks like you’re provisioning for an absolute peak year and yet still guiding to basically mid-cycle in our view, if you include the RFM business. So just wondering if you can reason between the discrepancies there.

Thomas Toepfer  
*Covestro AG - CFO, Labor Director & Member of Management Board*

Yes. So let me take the first one, Georgina. First on capital allocation. And on your notion that we will be net cash positive. So not exactly sure where that notion comes from. I would say, you have to take into account if you take end of Q1 as a starting point that there is the EUR 1.6 billion payment for the RFM acquisition out of our cash position. So my expectation, therefore, obviously would not be that we'll be net cash positive, but we will have a net debt position at the end of the year. However, we will have a very solid balance sheet notwithstanding, I think that is also clear.

In terms of capital allocation, I would say our priorities are, as we stated them in our full year earnings call, so therefore, CapEx is our #1 priority because we do think that it is the basis for future profitable growth. And we will have a very strict prioritization with respect to what is the return that we can generate from these projects. So it's not about let's keep pace with any growth numbers, let's go for market share or anything, but really how can we extract the maximum value out of the investments that we're making. That is the #1 criteria here.

Our second priority in terms of allocation is the dividend. And you've seen that we have adjusted the policy such that in a very good year that enables us then also to pay a highly attractive dividend. And I think, obviously, 2021 is very promising also in that respect. Number 3 would be M&A. I would say currently, our focus is absolutely on the integration of RFM. I know that investment bankers always put a tick mark to the deal once the signing has happened.

But for us, really the integration work is the key priority because it is, first of all, the basis for the synergies that we have promised, which we are absolutely pursuing, and the EUR 120 million is the clear target. And secondly, we think we should not distract our attention, but really earn the credibility that we can also well execute M&A.

But then, of course, in 2022, M&A is in the cards because it always was part of our strategy. And therefore, you know we're highly selective in terms of it has to create financial value, but also it has to make strategic sense. And if we find things that tick both boxes, that would be something that we would have a close look at. And last but not least, we said things like share buyback would be rather
something that we would pursue opportunistically and not as a key priority in our capital allocation.

So I think that would be what I would say on the capital allocation. Secondly, on the bonus, just to be clear, we have a bonus, which is essentially a profit participation scheme. And it is, of course, the core volume growth that is one of the key drivers of a very high bonus achievement even though the EBITDA level, as you correctly characterized it, is not yet at the peak that we had in 2017 and '18.

So remember, the 3 key drivers is the core volume growth, it's the free operating cash flow, and it is the return on capital employed. And in this year, it is especially the recovery and thereby, the core volume growth, that drives this high bonus achievement. So again, in terms of numbers, we're talking about EUR 400 million more accruals in our EBITDA relative to 2020, where the accrual was a low double-digit number. That gives you the order of the magnitude. And that will then become fully cash effective as a payout in 2022 in our free operating cash flow. Markus, you wanted to make one more additional statement here.

Markus Steilemann
Covestro AG - CEO & Chairman of Management Board

Yes. Just finishing off on that bonus, if you would take for 2022 the current EBITDA levels -- let's say then in 2022 happening, the bonus would be much lower, simply because at same EBITDA levels you would not have the similar effect, as Thomas alluded to, on core volume growth and also most likely on free operating cash flow, and that's why bonuses would come back to a more average level of, whatever, 100% target achievement, for example, just speculating on that one.

Georgina, you also raised the question on the investment in the U.S. on MDI. As we have always announced, we are going to review that investment in the second half of the year and here most likely in the fourth quarter. And then you also alluded to potential impacts on our new circularity vision.

I mean you are a chemist by training as far as I'm informed and you might understand that investing into MDI does not hamper our circularity ambitions as long as we make sure that the input raw materials, for example, would come from renewable sources, take, for example, benzene. And as long as we make sure that the products that we deliver to all of our customers at one point in time are shipped back to partners or even to us so that we can extract the respective molecules again. It might, in the long run, maybe even lead to the fact that we could skip some of the investments, but not for the investments in the U.S.

Here, we would go for the entire so-called train. That means we would build not only MDI, we would also build some of the precursors. And then if we want to go circular here, we could definitely then buy renewably sourced benzene, by the way, which we do already for parts of our production here in Europe, where we buy from the company Total. And we have recently announced that already renewably sourced benzene that goes partially already into a test phase for our MDI production. So circularity and that investment in the U.S. are not contradicting each other.

Operator
(Operator Instructions) And now we come to the next question from Laurence Alexander, Jefferies.

Laurence Alexander
Jefferies LLC, Research Division - VP & Equity Research Analyst

Could you give a little bit of perspective on pent-up demand in the furniture market, particularly looking at your kind of benchmark for the full year end market demand growth? Do you expect Covestro to be able to outgrow that market? And also, as furniture demand recovers, should you have a positive mix effect?

Markus Steilemann
Covestro AG - CEO & Chairman of Management Board

Yes, Laurence, very good morning to you, I assume that you're in the U.S., so let me give an answer. The pent-up demand in furniture, the bottleneck, why we haven't seen that strong demand was not a demand issue, but what it was a supply issue in terms of limitations for polyls. And if you take the chemistry into consideration, to produce a soft foam, you need 2 parts of polyls and one part of TDI, just roughly speaking. That means whenever you are short in polyls, that significantly hampers the opportunity to sell also in that context TDI, and therefore, significantly drives down the opportunity as we were short in supply to really capture the still strong demand for respective applications in the market.
Chetan Udeshi  
**JPMorgan Chase & Co, Research Division - Research Analyst**

A slightly different question than usual. I was just trying to understand, can you maybe help us with any data or insights into what is the recyclability rate for polyurethanes and polycarbonate in general? It seems for the whole plastic industry, the recyclability is still pretty low, 15% or so. I mean I was just trying to understand how much it is for polyurethanes and polycarbs.

Markus Steilemann  
**Covestro AG - CEO & Chairman of Management Board**

Chetan, thank you very much for the question. And I would say the recycling rate is still improvable, yes, so to put it that way. Honestly speaking, there is very limited amount today of polyurethane components being recycled, be it for rigid foams or be it for soft foams. Simple reason is most of these materials are not accessible for classical so-called mechanical recycling that you normally use for example for PET bottles.

However, the entire industry is not only putting significant research and development efforts into this topic, but we see already first successes where we could go for advanced recycling methodologies that would add up to the mechanical recycling opportunities. And here, particularly, so-called chemical recycling.

And what many companies are currently working on is, for example, soft foam mattresses because every year, a few hundred million soft foam mattresses are produced and a few hundred soft foam mattresses are currently either disposed in landfill, are mechanically recycled, but therefore downgraded, for example, into carpets. But also an even larger part is currently used as an exchange for fossil fuels and being incinerated, for example, for the production of concrete or other purposes, for example to recover the energy and produce, for example, electricity.

So long story short, currently, there is a super, super limited amount of soft foam as well as rigid foams being recovered. However, we have recently made a breakthrough discovery, which is we can now extract the building blocks from soft foam mattresses and use those building blocks to produce entirely new soft foam mattresses without any compromise on quality and hygiene standards for the end consumers. And we have successfully demonstrated that recyclability already in a pilot plant that is running since now 4 weeks at our operations in Leverkusen, Germany.

That means we have not only lab scale, but also technical scale currently demonstrated that this works, and that has gained significant traction also with value chain partners in the industry. That means we see huge opportunities in closing the loop here on this very, very large consumer product market for soft furniture and soft mattresses. And that's why we are very confident that within the next decade, we will see significantly ramping up recycling rates also for this respective application.

And what is the main difference for our recently developed and now in the lab scale and technical scale tested process, that we not only can recover the respective polyols, which many other current suggested approaches also can do, but we can also recover the precursor for TDI. And that is absolutely new and based on our knowledge currently in a continuous process, not possible. And that's why we see huge opportunities here.

Isha Sharma  
**Stifel Europe, Research Division - Analyst**

The first one is a reference that I want to make. The Dow CEO expects polyols tightness to continue and also mentioned that he expects good operating rates through the year at isocyanates, mainly driven by demand in construction and automotive. He also mentioned that the inventory buildup might only be possible by Q4. Would you subscribe to that view?
And the second one is for Markus. Markus, you mentioned at the start of the call some opposing trends which gives you less visibility. Were you referring to the regional development or end markets? Could you elaborate on that, please, a little bit? And just the last one on the Q2 guidance, what needs to happen for you to achieve the upper end of the guidance?

Thomas Toepfer Covestro AG - CFO, Labor Director & Member of Management Board

Isha, let me start with the last question. What has to happen to achieve the upper end of the guidance. Simply speaking, nothing, in the sense that the upper end of the guidance assumes that the prices will stay at the level where they currently are. The midpoint of the guidance already assumes a certain decline starting in June, which we currently don’t see yet, just to be very clear, because our visibility only is into the April numbers, which we have and then, of course, into May. But as also for the entire year guidance, we wanted to stay cautious also as for the second quarter.

With respect to the full year, it’s always good to hear that others are more optimistic. That is good. I think we are maybe by nature and character a little bit more cautious, and therefore, I think for our guidance applies the thinking that I had described in the earlier question. So we do assume and factor in a decline in margin in the second half of the year, full stop, which we currently, however, don’t see, and therefore there is a certain cautiousness built in.

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

As you directly addressed the question on the opposing trends to me. There is a bigger picture and a more specific picture. The bigger picture is, if you look at the current development of the pandemic, we still have to say that some countries, obviously, are doing very well. Some countries at least have seen the end at the light of the tunnel, but some countries are still in a catastrophic situation. Many countries, for example, in South America, but also just mentioning the Indian subcontinent in this context.

So therefore, we will maybe see a very mixed picture in terms of overall economic growth. I’m very positive about the development in the United States, positive about China and, let’s say, cautiously optimistic about at least some countries in Europe. But other than that, we also will see countries and also respective economies where the overall situation in terms of demand will not improve and maybe not improve for a very long time. So that’s the overall picture why we see this opposing trends.

And if you just now particularly look at our respective industries, what we also have elaborated in our presentation when we talked about the so-called industry utilization, And here, particularly the utilization based on available capacity due to many unplanned shutdowns or simply no availability for some players on raw materials, there is an opportunity. And for example, short term, more available capacity will come to the market, which will then bring us closer to the lower end of the guidance.

However, there is also the midterm market trend that those capacities will be quicker or slower being absorbed. And for example, we can also expect to get a short market in MDI and also slightly better market over time in TDI. So it is basically another reasons behind what Thomas has alluded to in terms of our limited visibility in the third and also in the fourth quarter. And therefore, also our current challenge in terms of the full year guidance and here, in particular, on the second half. So that is a little bit the full picture. It is all, in the end of the day, the same phenomena what we’re describing.

Operator

And the next question comes from Sebastian Bray, Berenberg.

Sebastian Bray Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst

I would just have one, please, on the DSM resins acquisition. If this business is doing slightly better than in the business plan made at the time of the acquisition, let’s say it’s doing 160 million to 165 million of EBITDA this year, I struggle to think that it will not contribute at all during the course of the year, if it’s going to be contributing pre-integration cost, let’s say, EUR 110 million, EUR 115 million of EBITDA. Can I just clarify a point here, what is the magnitude of integration costs that you are expecting for 2021? And is the correct way to think about modeling this for 2022 that the large integration-related expenses are done at the end of this year?
Thomas Toepfer  
Covestro AG - CFO, Labor Director & Member of Management Board

Thanks, Sebastian. This is Thomas. I'm not sure whether I fully got all your details on the question. So let me try to explain our view on this. So first of all, what we said is that the RFM business has a EUR 150 million EBITDA per year, that was what we had in our business plan. That is excluding the innovation business. We said at the time, the innovation business had a negative EBITDA, and we essentially got it for free, if you so will, in the acquisition.

So now 2021, we said they are tracking slightly above the business case. That is absolutely true. In 2021, we have the following effects. First of all, we will include the EBITDA for 9 months. And against that, we will have the integration costs and also an inventory step-up which has a negative effect of EUR 20 million to EUR 30 million. So overall, the impact will be slightly negative in 2021. And then in 2022, you will see the full operational EBITDA included in our numbers plus the first synergies that we will then already have in the next year. Does that answer your question, Sebastian?

Sebastian Bray  
Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst

Yes, indeed. If you could just explain the mechanics of this inventory step-up. Why would that necessarily reduce the contribution of the business?

Thomas Toepfer  
Covestro AG - CFO, Labor Director & Member of Management Board

The inventory valuation has to be reflected in the EBITDA, and it is a pure accounting effect, it's not operational, but we will have to reflect it into our EBITDA.

Operator

And the next question comes from Markus Mayer, Baader Bank.

Markus Mayer  
Baader-Helvea Equity Research - Lead Analyst of Chemicals

Markus Mayer from Baader Bank, only one question remaining. We've heard from several customers from the automotive industry, and particularly the private owned chem companies, that they have been double sourcing, in particular, from automotive customers. And therefore, my question is, do you see a risk for a sharp demand stop then in the second half if then potentially oil prices coming down a little bit or at least the demand is not as strong as the industry is hoping for? And I guess this in particular then could be the case for CAS or for the PCS business.

Markus Steilemann  
Covestro AG - CEO & Chairman of Management Board

Markus, this is Markus speaking. Well, we heard a similar but really only anecdotal stories from some of our customers. And in the end, our assessment for the majority of those were that double sourcing simply was not possible for our products. That might be here and there happening in other areas. Nonetheless, for our products. First and foremost, we see still a continued very high demand for some of the products that we're selling into automotive. We see also good growth for the entire year.

You might argue whether it's too high or too low, the assumption that we have baked in. Nonetheless, we do not see that for our products, this double sourcing is really successful. Whatever we produce, customers want to have, they immediately use. And we also must not forget that some of the materials we are producing are not only made to order. So really highly special products where it's difficult to have double sourcing.

Or they are commodities, but commodities that means then they are sometimes sold in spot markets and you cannot store them for long simply because they are highly reactive chemicals. That means also here, we have sufficient, at least from our perspective, insights that we do not expect that customers are sitting on high inventories or that the order books are filled for the reasons of double sourcing attempts. So therefore, I would not see this as a major negative potential impact on the business to come.

Operator

Mr. Koehler, there are no further questions at this time. Please continue with any other points you wish to raise.
Ronald Koehler  Covestro AG - Head of IR

Thank you. Yes, it's a very good timing, 4:00, so sharp. So from that perspective, I thank you all for your interest and for your questions. Obviously, if you have follow-up questions, don't hesitate to contact the IR department.

And with that, I would like to close the call. A quick remark due to the RFM integration, we slightly postponed the Q2 conference or, better to say, the release of results, just to change that date in your calendar as we have earmarked that at the presentation. Thank you for listening in. Bye.

Operator

Ladies and gentlemen, this concludes the earnings call of Covestro. Thank you for participating. You may now disconnect.