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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Covestro Investor Conference Call on the Q3 2017 results. The company is represented by Patrick Thomas, CEO and interim CFO; 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 third quarter conference call. For your information, we have posted our Q3 quarterly statement and the conference call presentation on our website, and we assume you have read our safe harbour statement. I would like now to turn to Patrick.

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

Good afternoon, everybody, and Ronald, thank you for the introduction. In quarter 3, we delivered the strongest quarter in the company's 80-year history. To put this in perspective, in the first 9 months of this year, we generated an EBITDA of EUR 2.5 billion, which is already EUR 0.5 billion ahead of the full year EBITDA for 2016. Before moving to the financials, I'd like to highlight the tremendous efforts made by our U.S. management team to cope with the impact of Hurricane Harvey. Thankfully, none of our employees were injured by the hurricane. Still, nearly 150 Covestro employees were personally impacted through damage to their homes, cars and belongings. A major coordinated effort was made with local and regional crisis teams to support them. I just want to thank everyone involved for their support in this very important rescue. In terms of the financial impact to our company, we lost production volumes of around 45,000 tons. This translates into an impact on the core volume growth of 3 percentage points in the quarter. Otherwise, we would've grown our core volume around 6% this quarter. The negative impact on EBITDA is estimated at mid-double-digit millions of euros. Despite this, we delivered an impressive set of results in quarter 3. Our core volumes grew 2.6%, based on a continued strong demand in the polyurethanes and polycarbonates industries. In tight industries with correspondingly high utilization rates, we could further improve our earnings with a year-on-year EBITDA increase of over 50%. Looking at the first 9 months, this leads us to an EPS of EUR 7.13, an improvement of over 100%. Including the expected strong fourth quarter, this implies a P/E ratio of well below 10, making our shares the most attractive investment we could find. Our ability to generate high free operating cash flows is unabated, delivering EUR 1.2 billion since the end of 2016. These outstanding operational results led to a reduction of our net debt to EUR 542 million at the end of September - a reduction of almost EUR 1 billion in the last 9 months. Let me provide you with some more insight into our core volume development by region and by industry.



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Our volumes in quarter 3 suffered from external factors. In the U.S., we faced limitations in all 3 business units due to Hurricane Harvey, while in Europe, we faced limitations on reliable supply in Europe through the railway interruption affecting logistics during 6 weeks on one of the main continental railway lines along the Rhine. In addition, we had to cope with constrained product availability in Polycarbonates due to a slower than planned restart of our production at the Uerdingen site after a scheduled maintenance turnaround. Thanks to the underlying robust demand growth, especially in China, we could still record a solid core volume growth globally in quarter 3. Indeed, we saw broad-based demand across our major customer industries. Our core volumes grew mid-single-digit in Automotive, in Electronics and in the Wood and Furniture sectors. In medical and in other diverse industries, we again saw double-digit growth rates. This illustrates, once again, our growth momentum, as we are able to leverage our unique ability to benefit from overarching megatrends, such as climate change, mobility evolution, population growth and urbanization. We will continue to grow our volumes organically above GDP in the long-term. Overall, the first 9 months of 2017, we delivered a solid core volume growth of 3.2%, respectively around 4.5%, adjusted for Hurricane Harvey. Our sales development in the third quarter of the year continued to be very strong, driven by the Polyurethanes and Polycarbonates segments. Volume, and to a much larger extent price, positively contributed to the growth. For the first time this year, we saw a negative impact from FX effects. Our EBITDA improvement in quarter 3 was again on a similarly high level as in quarter 1 and 2. We grew EBITDA by 50% versus the prior year quarter. This was mainly driven by a strongly positive pricing delta in TDI and MDI. Although, we faced significantly higher raw material prices, we were able to increase selling price even more due to the continuously tight situation in our industries. The residual position "other items" contains, as usual, the negative impacts from a number of numerous smaller effects. Also in EBITDA, we've recorded a slight burden from FX for the first time this year, mainly driven by translation effects. Overall, EBITDA margin improved from 19% to 24.4% in quarter 3, 2017. However, this margin should be put into perspective. Excluding the TDI fly-up affect, our margin would have been around 21%, a level I would deem more appropriate to reflect this quarter's performance. Overall, we were able to increase our EBITDA each quarter versus the respective prior year in the last 11 quarters. I'm now pleased to be able to hand over to Markus for more detail on our individual segments.

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

Thank you, Patrick, very much indeed, and welcome from my side. The current demand for polyurethanes is strong, driven by the accelerating global GDP growth, coupled with the structural growth component. As we highlighted in our capital markets presentation, polyurethane is more than proportionally geared towards the construction industry. So far, we assumed a global growth of the construction industry of around 2% and a growth in polyurethane insulation material of 5%. The growth in the global construction industry now accelerated from 1.8% in 2016 to an estimated run rate of 3.3% in 2017 and upcoming years. Besides strong demand in construction, the industry should benefit from several trends like ever larger refrigerators, strong growth in offshore wind energy and an expanding global cold chain with the help of reefer containers. As a consequence, it seems likely that global demand in MDI will grow with 6% to 7%, possibly above our budgeted growth rate of 4% to 5%. By the way, this development would be in line with the long-term growth seen before the financial crisis. As you know, we enjoy a high visibility on additional supply, given the long lead time of 7 or more years to build a new world-scale plant. Based on the current demand growth rate in MDI, the industry needs at least one new world-scale plant every year. It will be tough to match this demand growth as we expect only 4% supply compounded average growth rate between 2016 and 2021. As a consequence, we assume a structurally further improving global utilization rate over the next years. The picture in TDI is different. The global industry is currently sold out. However, we expect double-digit supply growth over the next 12 to 24 months, compared to a demand growth of 3% to 4%. As a consequence, we assume that industry margins will normalize. However, predicting the timing of this normalization is difficult. We have now enjoyed 3 quarters of fly-up contributions in TDI and our segment EBITDA benefited by almost EUR 400 million. We even achieved our highest monthly margin level post-financial crisis last month, which provides a very nice starting point for Q4, 2017. We believe margins may normalize in second half of 2018. Polyether Polyols currently suffer from the supply constraints in TDI. A flexible polyurethane foam consumes 1 unit of TDI and 2 units of polyol. The limited global growth in TDI is now restricting the use of polyols. At the same time, the demand is strong for the jointly produced chemicals, styrene and MTBE. As a consequence, many PO/MTBE or and PO/styrene producers run their plants flat out despite the limited demand for PO. This imbalance leads to some price pressure for polyols, which we believe should reverse when TDI returns to normal growth. We have established a new earnings level at the beginning of 2017. Even excluding the benefit from the fly-up margins in TDI, we have seen a steady underlying margin improvement from 19% in Q1 to 22% in Q3, driven by our positive volume leverage and higher margins in MDI. This margin increase continued despite the recent shipments from the new MDI and TDI capacities in the Middle East, which underpins our confidence in a robust demand. We assume we can defend the newly established underlying earnings level over the next years. In addition, we continue to target a volume growth in line with the polyurethanes industry, which provides a steady top and bottom line benefit. In Polycarbonates, our core volume growth was slightly positive in Q3 2017 due to constrained product availabilities in the U.S. and Europe. Besides the impact of Hurricane Harvey in the U.S., the slower than expected ramp-up after the planned



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shutdown of our Uerdingen plant in Germany limited our growth. For the first 9 months, we delivered a solid core volume growth of 5.4%. Growth was broad-based, driven by all 3 regions. While we achieved double-digit growth rates in automotive, medical and diverse other industries, we deemphasized our sales in highly commoditized applications like sheets in the construction industry and the CD/DVD industry. In Q3, EBITDA increased by 8.8% year-on-year helped by these product mix improvements. After a negative pricing delta in the first half year 2017 due to higher raw material costs, the intended catch-up planned for the second half of 2017 is successful. Indeed, the pricing delta was positive in Q3 2017 thanks to increased selling prices, overcompensating the higher input prices. In Coatings, Adhesives and Specialties, our core volumes decreased by 5.0% year-on-year, driven by 2 factors. Firstly, we saw destocking in the market and a weak underlying demand, especially in industrial coatings. Secondly, we faced product limitations in the U.S. due to our declared force majeure and had setbacks in Europe due to the interrupted railway connection. EBITDA decreased by 12.5% year-on-year to EUR 119 million, affected by the negative volume leverage. In line with the expected phasing of the announced price increases, we achieved a 3.8% year-on-year price increase in Q3 after a 0.6% in Q2, enabling us to compensate the impact of higher raw material prices. For the full year 2017, the earnings situation remains challenging. We expect to face the usual seasonal dip in Q4 and have to see how the volumes will evolve until year-end. We are still confident that prices will continue to slightly improve during the coming quarters. At the same time, the expected relief from raw material costs did not materialize in Q3. From today's perspective, we might even have to cope with increasing raw material prices for several quarters. Despite this, CAS remains an attractive resilient business with EBITDA margins above 20%. Now back to Patrick.

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

Thank you very much, Markus. In the first 9 months, we were able to generate another record free operating cash flow of close to EUR 1.2 billion. The strong improvement continues to be driven by the EBITDA increase and low income tax payments. Negative working capital contribution, higher CapEx and the payout for bonuses, partially offset the development. The working capital to sales ratio reached 17.6%, which brings us close to the year-end goal of being back into our target range of 15% to 17%. The overall higher working capital is driven by higher selling prices, which leads to higher values in inventories, and of course, higher receivables. The benefit from low cash outs for taxes is purely a phasing effect. The shift can be well observed by comparing the cash tax rate level of 4.8% at the end of June with the quarter 3 reaching 13.7%. For the full year 2017, we expect the cash tax rate to be several percentage points below the expected P&L tax rate of around 28%, still influenced by the same phasing effects. The ratio of total net debt to EBITDA slightly decreased further to reach 0.6x at the end of September compared to 1.3x at the end of 2016. The net financial debt level decreased by almost EUR 1 billion since the end of last year to reach EUR 542 million at the end of September 2017. At this run rate, we would be debt-free at year-end. As you know, a total debt to EBITDA ratio of 2.5x is sufficient for a solid investment grade rating. Nevertheless, we stick to our target of 1.5x. After our recent record cash flow generation, the question of use of free cash has gone to the top of our agenda. Therefore, let me remind you of our goals with the slide I presented at the last Capital Markets Day in June in London. We made the commitment to deliver EUR 5 billion of cumulative free operating cash flow until year-end 2021. After the strong results delivered year-to-date, we are reviewing this target. We promised to return excess cash to shareholders after 24 months, which would have been mid-2019, but due to the simultaneous appearance of several factors, we decided to accelerate the cash return to our investors. Let me explain the rationale of our decision. Firstly, the fly-up in margin in TDI has led to a higher than expected free operating cash flow generation. As a consequence, the buyback is possible based upon our current net debt level while maintaining our solid investment grade rating. Secondly, the daily trading level of Covestro shares is now higher than expected due to the faster than anticipated placings by Bayer, leading to the current free float of 74.5%. Finally, and really most importantly, after screening several immediate external growth opportunities, the share buyback represents, clearly, the best value creation option today. Therefore, the Board of Management decided to start a share buyback for either up to EUR 1.5 billion or 10% of stock capital, whichever is reached first, without further delay. This move does not alter any of our previously communicated use of cash plans. We remain committed to our dividend policy and we continue to screen the market in a disciplined way for external growth options, which will create value as our key focus. We reiterate our group guidance of a low to mid-single digit core volume growth for the full year 2017. To be more precise, we expect to achieve a similar core volume growth for the full year as posted for the first 9 months. We continue to assume a free operating cash flow for the full year 2017, significantly above the average of the last 3 years. We also expect a further improving ROCE leading to a level that will significantly exceed that of 2016 as well. On EBITDA, we also reiterate the guidance that our EBITDA will significantly increase for the full year 2017 compared to 2016. For EBITDA in quarter 4, 2017, we foresee a significant increase versus the EUR 390 million in quarter 4, 2016. As explained, the industries are expected to remain tight and global demand growth is broad-based. As a consequence, we assume that we can achieve a year-on-year pricing delta of almost EUR 300 million in quarter 4. Some final words prior to closing the presentation and handing over to your questions. After 9 months into the year, we can definitely say that we are heading for a record year. These results will clearly raise the bar. Global GDP growth accelerated, which drives the demand for our products to a new level. Despite our capacity constraints, we are confident to keep track with the above GDP



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growth of our industries. This will be enabled by smart CapEx short-term and with new investments long term. This should allow us to generate a record free operating cash flow over the coming years. Currently, we see our shares as the best value creating investment opportunity for our excess cash, and as a consequence, we will start buying shares back without delay. We are now open for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Mr. Faitz.

Christian Faitz - Kepler Cheuvreux, Research Division - Equity Analyst

Christian Faitz here, Kepler Cheuvreux. Pretty self-explanatory Q3. Two questions, please. What do you believe needs to get done to improve the performance of CAS? And second, how do you currently see demand from the automotive industry on a global scale? Maybe if you can discuss this region by region.

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

Thank you, Christian. I'm going to ask Markus to talk about CAS and then I will talk about automotive, and thank you for your congratulations. We really appreciate that. Thank you.

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

Hi Christian, this is Markus speaking. So if you look at our CAS results, it might help to look at the underlying reasons why you might have a few question marks on the performance of CAS. But first and foremost, CAS currently maybe looks as it looks because the polycarbonates and the polyurethane business is so very well performing but if we now talk about the CAS business, we just see that we have here the effect of our core volumes really going down by 5% year-on-year within the third quarter and that for 2 major reasons: We really saw that after we tried to stop the ever declining prices over the last couple of quarters that we have seen and really pushed very hard to stop this process, there was obviously a little bit more material in the supply chain than we initially assumed when we started the price increase, and that then lead to the effect that we achieved finally, slightly increasing and later on also significant price increase but at the cost of losing some volumes. And that is the major effect actually of this action we have seen in the third quarter. And the second effect is, we had this setback, in particular, due to the fact that we needed to declare force majeure in the aftermath of the Harvey impact and we also had the setbacks in Europe due to this heavy interruption of one of the main railway lines that goes from south to north in Europe and that very much limited our abilities to supply in the market. So that means, if things are back to normal, and meanwhile, we have lifted the force majeure in the United States, the railway tracks are not fully recovered as far as I know, however, we have alternative logistics opportunities. The overall business should be back on track in due course, and not to forget, we still talking about margins above 20% because CAS remains an attractive and it remains a resilient business overall.

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

Thanks, Markus. And Christian, to answer your question about automotive at the sort of real macro level. The way we look at growth in global car production is, we would say, that the basic CAGR is around 3%. What is relevant for us is a subsegment of that market, which we see a CAGR of 5%. And actually, in the third quarter, we saw a Covestro growth level of about 7% in automotive, if I can give a bit more color on that just as to where that was coming. There's quite an intriguing effect caused by the shortage of TDI, which means that there was significant growth on MDI in transport and automotive of around about 16% offset by a reduction in growth in TDI. That's because in automotive seating, a lot of companies use a blend of MDI and TDI and they have some degrees of flexibility to change the ratio, and therefore, when TDI is very short, you tend to see a growth of MDI in automotive, we've certainly seen that. The strongest growth in quarter 3 occurred in the polycarbonates sector, which again, was around



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about 12% growth. So year-to-date, we're seeing pretty much a growth level of around about 8% to 9% overall against our target rate that we would normally aim for in this sector of about 5%. So we are seeing outgrowth. If I can try and explain where some of that is coming from. It's back to electromobility. You've seen a lot of countries taking positions at the moment on electric vehicles. You've seen sales volumes increasing. China, last year, certainly made more electric cars than everybody else put together. And we put about 3x as much product into an electric vehicle as we do into a conventional vehicle. So we see that as a key driver, 1 of the 3 key drivers for our future. Is that helpful?

Christian Faitz - *Kepler Cheuvreux, Research Division - Equity Analyst*

Yes, absolutely. Very helpful.

Operator

The next question comes from Charlie Webb.

Charles L. Webb - *Morgan Stanley, Research Division - Equity Analyst*

Charlie Webb here from Morgan Stanley. Just a few questions from my end. First off, around inventories. Could you possibly just run us through where inventories sit in MDI, TDI and Polycarbonates, and then given what I think is probably a very tight situation, at what point you'd expect to have normal levels of inventory? That's the first question. Second question, just on Hurricane Harvey on the volume impact. Is that 3% volume impact across all divisions roughly the same or was it particularly Polyurethanes? And if so, what was the volume impact for Polyurethanes? And then lastly, just a more high-level question, given current pricing, I mean, you talk a bit of switching in from TDI to MDI in automotive. In MDI, at current prices, have you seen any switching to other insulation foams or any insulation products or not? And could you envisage a situation where we will see more switching?

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

Okay. Thanks, Charlie. Three good questions. I'm going to hand over to the inventory expert, Ronald, to explain where we are in MDI, TDI and Polycarbonates to start with. And then I'll explain a little bit about Harvey, and Markus will explain about MDI substitution.

Ronald Koehler - *Covestro Aktiengesellschaft - Head of IR*

Good. Yes, to your inventory question, Charlie. Clearly, the Hurricane Harvey had an impact. We lost 2 weeks of complete production. We did not lose that completely I say because we decided to actually reduce our inventories and use our inventories as much as possible to fulfill all the customer orders. So, we could have had sold more if we would have more available products. So inventories are down, more down than we ever actually planning, which will have a spillover effect in the fourth quarter. So you might remember, last year we had the force majeure situation in the fourth quarter, which actually, initially, we thought it's a very nice basis for growth. However, as you have the need to replenish some of the inventories. We will see some growth but not such a kind of good growth we have initially expected. So that is something we need to do in the fourth quarter. Also to remind you, we will have a significant shutdown in Polycarbonates as an example of maintenance in the first quarter of 2018, but we also have to build inventories. So inventories, ton-wise should go up. Be aware, the value in the balance sheet which you saw increasing year-on-year is purely driven by the price increases we see for the product. So in the year-on-year comparison, inventories are down in tons.

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

Thank you, Ronald. When we look at Harvey, we said 3% overall effect and it was pretty much across everything. And I think we declared force majeure for most products in the U.S. with the exception of PCS, because with PCS we actually have other locations in America that are carrying out compounding operations and conversion operations, which means that there was quite a lot of material not down in Texas at the time. So we



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had a slightly easier time in PCS, and you can see that when you look at the growth numbers. The best thing was that 45,000 tons of core volume that was lost was compensated for, in part, by inventories, some of which was on our own site and some of which was actually in consignment with customers. So if you want to model it across everything, I mean, I really don't think it's easy to ascribe specific product lines to that Harvey effect. MDI substitution, we talked a bit about the effect of TDI MDI swap over, which can occur in some applications, but the question was specifically from Charlie on insulation. Markus?

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

Thanks, Patrick, and hi Charlie. So if you look at MDI, generally speaking, the risk of a short-term substitution of our products through alternative polymers or solutions is rather small. Why is that? MDI and its resulting polyurethane rigid foams are amongst, if not the best, insulating material in terms of performance per thickness, if you want to say so. So from that perspective, it is very difficult to replace it because you normally talk about entire construction principles and that's why our customers refrain normally from using alternative materials. Moreover, even some alternative systems that are out there still use polyurethane as a binding agent. So even if there would be some replacement, we still would benefit also here from isocyanate sales into those respective systems. But overall, we see the short-term substitution risk as rather small. I hope that helps.

Operator

The next question comes from Mr. Benson.

Andrew Benson - Citigroup Inc, Research Division - MD

Andrew Benson from Citi. Can you give us a bit more detail on the timing or how you see the timing of the buyback and just whether in a buy up, for example, could tender another EUR 1.5 billion, how you tend to approach the buyback? The polyols situation you said that was in danger of going long. Can you just update us on your polyol strategy noting you don't have capacity in Asia at the moment? And just give us an idea of when the tax rate will tax paid in -- tax accrued will normalize and whether that means tax -- cash tax paid will go up in the medium term.

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

Thank you very much, Andrew. Timing of buyback. Let me explain what we can and cannot do with the buyback. So the plan will commence immediately, that's the easy starting point during the fourth quarter 2017, and we estimate that it will have a duration until around about mid-2019. It could be faster than that but it depends upon the rate at which we can feed shares or pull shares out of the market. So we plan to execute as fast as possible but we need to do that in a manner which does not disturb the market or distort price. We have to do this in accordance with the EU Safe Harbour rules, of course. So that means there's a limitation of 25% of those extra daily trading volumes can be purchased with the scheme. We're looking at doing the purchase in a way that would consume our 10% allowance. But it has to be remembered that when we come to the annual shareholders meeting next year, we can reopen that allowance back up to 10% with shareholder approval, if that was possible. The share back will be executed through the Frankfurt Stock Exchange. So you were suggesting that maybe our former parent has some insight track or something like that is impossible in our situation. There will not be any plan of tender. So the rebuying is through the normal regulated environment of the Frankfurt Stock Exchange. Is that okay, Andrew? Makes sense?

Andrew Benson - Citigroup Inc, Research Division - MD

Yes, that's great.

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

Okay. Polyols, Markus?



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

Hi Andrew, this is Markus speaking. So if we talk about polyols, the current situation is that the market is already a little bit long, that means a little bit oversupplied, simply due to the fact that not so much polyol is consumed due to the ratio that is associated with the usage of polyol in the context of TDI usage. So the TDI supply constraints given a very strong demand of TDI is somewhat limiting the consumption of polyols. At the same time, the core products that you normally have with polyols or the, let's say, underlying raw material propylene oxide are MTBE and styrene. And here, the demand is currently rather strong on MTBE and styrene, which leads to the fact that some of the producers run their plants flat out to get as much MTBE and styrene as possible, and with that even further oversupplying the market with propylene oxide, and therefore, there was the raw material for polyether polyols. So that's the current situation. With regards to your remark on the supply situation in Asia Pacific, we have access to polyether polyols and propylene oxide in the United States as well as in Europe, and you are right, we do not have own production capacities in Asia Pacific. And overall from a global perspective, as we said already earlier, we are somewhat limited short to midterm to support the market growth in polyether polyols. However, mid to long-term, we have options to also continue to grow in polyether polyols.

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

Thank you, Markus. I'll hand over to Ronald to just answer the question around more detail on tax.

Ronald Koehler - Covestro Aktiengesellschaft - Head of IR

Good. Yes, the tax rate. Obviously, we're talking about the P&L-related tax rate around 28%, which we reiterated, so unchanged on that. We also said that the cash tax rate will be several percentage points below that. Why? Obviously, our results are developing so nicely and better than, let's say, the prediction delivered to the tax authorities. Quite often they actually do take taxes according to historical numbers. So therefore, there is a delay effect. And that means we might have a cash tax rate of, call it, only 23%, 24% at year-end. And if we then coming to a more steady state development of earnings, then there might be, let's say, a catch-up effect most likely in 2018. So there is a bit of this phasing and there will be a bit of this phasing in 2017 versus 2018.

Chetan Udeshi - JP Morgan Chase & Co, Research Division - Research Analyst

Chetan from JP Morgan. Yes, on cash, can I clarify that the volume decline that you saw in Q3 was mainly a function of the impact from hurricane and some destocking or weaker demand after price increases. Because I think the result statement talks about challenging competitive environment, so I just wanted to confirm that point. And secondly, can you clarify how do you calculate the fly-up margin in TDI, so what is the underlying assumption, even if that's just a high-level assumption?

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

So Chetan maybe -- this is Markus speaking. On the CAS business, you are right. We are here talking first and foremost about the volume decline effect that had this impact on the overall EBITDA situation in the third quarter and that was due to the destocking effect that we have described. And in that context, we also faced the product outage or limitations in the U.S. where we declared force majeure. So these are the main 2 reasons that have left us with a volume decrease of 5% and that, overall, has led to the decline in absolute EBITDA. However, the overall CAS business remains very attractive with very healthy margins and in particular, resilient margins, which we expect to be above 20% also for the foregoing future.

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

Thanks, Markus. I think it's probably worth adding, Chetan, to add to perhaps what you're thinking about when you ask your question. This sector of CAS that we're describing is one of the smallest subsegments, which relates to aliphatic isocyanates and one isocyanate in particular, where



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indeed, in the press statement, it suggested there was increased competitive pressure and that's around HDI specifically, which is one of the components that makes up the multitude of products in CAS. And for that, there is now a bigger Chinese producer and one TDI plant in France was converted to HDI, which is managed by Vencorex, and I think PTT in Thailand. So there has been some extra capacity and that's why we were putting the prices up to try and reverse the trend there. Your fly-up margin question's a very good question, it's a perfectly fair question. So in TDI, we saw about EUR 130 million per quarter year-to-date of fly-up. In quarter 4, we expect a similar sort of number. So in total, somewhere between EUR 400 million, EUR 500 million for the year. I think it will normalize in the second half of next year. Difficult to predict exactly but I think that's where it feels about right. It does not compare the margin to a midcycle but rather to what I call a sustainable margin, which is above reinvestment level. So use that as the way of looking at it. I think that's the most helpful way. Is that okay, Chetan?

Chetan Udeshi - *JP Morgan Chase & Co, Research Division - Research Analyst*

No, the reason for the question was because if you see the spreads have actually gone up into third quarter than 2Q, so I would've thought maybe the fly-up margins should have gone up as well, but you seem to be suggesting that it was the same.

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

Yes, it's difficult. It depends where you're getting your data from. If you're using ISIS then it might mislead you a little bit. I am explaining what we are seeing. I think that's probably the best way of describing it. Very often, ISIS is calling on traders and other players to get their price data. What I've reflected is the fly-up margin based upon my assumption that we experienced.

Operator

The next question comes from Mr. Lambert.

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

Patrick Lambert, Raymond James. I guess, 2 questions. Actually, 3 questions. The first one is actually regarding Harvey but not the impact in Q3, but the impact going forward. Have you seen or can you share with us some signs of reconstruction efforts and I would assume that actually PUR goes in pretty quickly replacement cycles there on mattresses and insulation. So if you could share what you are seeing on the ground in North America even on the car industry or on the construction industry would be pretty nice. Second question on CAS again. Could you remind us what is the exposure to industrial and protective coatings inside of CAS? And last one pretty, I guess, midterm question. What can we expect from your digital platform efforts, which looks very interesting, especially in the commodity type of B2B business. If you could comment a bit on what you expect from that in terms of financial impact on EBITDA.

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

Okay, Patrick. This is Markus speaking, and I think I take your Harvey question and the digital question and then I'm very happy also that Patrick goes for the Coatings, Adhesives and Specialty question. So the impact on Harvey and your question also how that might spur demand. It is definitely the case that we are starting to see increased demand for construction materials but also for refurbishing, that means mattresses. But we were never concerned and we actually were not really very much looking for this additional demand because the current situation is that MDI is in a very healthy demand situation across all industries due to the reasons that we have already pointed out. Same applies for TDI even more so. For MDI, as we pointed out, it is for us, a very clear picture that we are entering into a phase of structural demand improvement. And therefore, structural supply demand balance improvement. For TDI, this will even further, let's say, contribute to the current very difficult supply demand situation that also had led in the last 3 quarters to those fly-up situations. So there is definitely more demand. But in all fairness, we have to say we are currently in a situation where, and it maybe sounds weird, we are not really looking for additional demand because we simply do not have sufficient supply to even go for further demand in that context. I hope that's helpful to give you some flavor.



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

Yes, can I -- a follow-up actually. Have you made a decision on Spain as a result of those revision of growth expectations, especially on MDI?

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

The decision on Spain is that we have, so far, suspended the closure of the MDI site in Tarragona, and that's the current decision status. It has not changed the previous announcement.

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

When do we expect a decision, again?

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

Well, you might expect a decision that we currently have suspended it, and I'm very sorry that I cannot get more detail on that. We are currently reviewing, really, all investment plans very carefully, very diligently, and I'm very sorry that I cannot go any further in this direction. So you also asked a question about digital business, and in particular, about commodity. I think one thing is very important, this digital platform that we have already established and where we are currently already having first sales in the order of magnitude of low double-digit million amount is from our perspective, providing several opportunity. It is not only about commodity sales but providing different business models to our customers. So we have here, first time, a very powerful tool at hand that will enable us to go for different type of products and simply providing different offerings to our customers, not necessarily only in the commodity business. We currently would project that we could sell up to EUR 1 billion sales of products via this channel cumulative until the end of 2019. And we are very closely, together with our customer, currently exploring different business models, experimenting with different business models. And by that, actually every day, learning from those experiments what services are required in the market, what additional business models we can drive jointly with our customers, what attracts them, what is a unique selling proposition, and we will build on this platform each and every day different business models and that also might lead to the fact that we will expand our product range. How the overall margin situation will look like through this channel, that's an entirely different story, which we have to really then observe once we know which product and business mix is really then going through this channel. And you can easily imagine if it is only commodities, let's assume for the time being, just for argument's sake, that goes via those channels, it just depends on in which, let's say, level of the cycle we are currently. So which supply demand balance we have that would then influence the margin levels relative to the rest of the business. If we, which can also happen due to all experience that we have made, for example, even go for some specialty products via this channel, which could be the case in some very specific business models, then the margin situation might be very different. So at current point in time, I would think it would be too speculative to talk about specific margin levels. Does that help?

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

Yes. Last question on...

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

Okay. Patrick, I think your last question related to our exposure to industrials in CAS. If you take the total CAS, we always break it down between Coatings, Adhesives and Specialties, which includes sealants. The definitions are slightly different. So if you talk to our customer base, it depends really whether you're in Europe or America as to how they define industrial because corrosion protection is another term that's also used for what I would call industrial, particularly in the coatings area. And then, obviously, quite a lot of the construction adhesives would be taken into our CAS business, we would call them industrial. I think the best range would be between 15% and 20% of our CAS business is mapping onto the sector, which I would call industrial, based upon the announcements that are being made by PPG, Akzo, all the other guys, Sherwin-Williams about a



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depressed industrial. I mean, the reality is the depressed industrial is around shipbuilding, particularly in marine coatings, and also around the oil and gas sector. So corrosion protection for offshore. Things like floating production platform, things like that. So I would take 15% to 20% of our CAS business is going into those type of industrial applications, okay?

Operator

(Operator Instructions) Our next question comes from Mr. Swoboda.

Thomas Swoboda - Societe Generale Cross Asset Research - Research Analyst

This is Thomas Swoboda from Societe Generale. I'm just wondering if you could give us a small outlook on the moving parts for 2018, if this is already possible. Firstly, a little bit more detail on volume. In 2018, there is no capacity expansion at your site coming. So I'm just wondering, can you grow your volumes? Can you grow along with the market in 2018 again? And then eventually, could you provide a rough earnings EBITDA bridge as you see it very rough for 2018?

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

Hi Thomas. This is Markus speaking. And I would like to talk about our opportunities to still grow in 2018 in terms of volume and then I would love to hand over to Patrick. Patrick will give you a flavor about what's going on there. So if we look at our 2018 opportunities, just look at the basis for 2017. Let's assume our core volumes would be around EUR 4.9 million tons of core product that we would sell into the market, we still have overall debottlenecking opportunities in place for PCS, MDI and TDI in the order of magnitude of 150,000 tons. Then as we have stated in previous calls already, we have contracts in place with some industry players where we go for exchange of materials, for example, over time. That means if someone is building a capacity, sometimes we have the opportunity to get parts of the capacity being delivered and then we give this quantity back at a later point in time or vice versa. If we look into our entire picture of so-called swaps, and particularly, time swaps that we have done, we still have roughly 50,000 tons outstanding that we need to get back. So we are so-called net in-swapper. Plus there are further factors that we need to take into consideration which have a minor effect, which will give us another 50,000 tons. Just to name 2 of them, this is the opportunity to sell off some inventories at the end of 2018 due to the start of Brunsbüttel because there's additional material coming. And the second would be that we have a lower jump off point simply due to the Harvey effect in 2017, so we could not fully leverage our available capacity simply due to this natural disaster. So if you add all this up, we would talk about maybe 250,000 tons plus, which would still represent 4% to 5% growth over the entire portfolio for 2018. I hope that helps.

Thomas Swoboda - Societe Generale Cross Asset Research - Research Analyst

It helps indeed.

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

So that gives you kind of volume component, Thomas. And I'm going to have a go at triangulating in 2 directions here. One is if I take the VARA consensus and I look at the, roughly, just under EUR 400 million gap between 2017 and 2018 that's forecasted, I could believe that, that could be right but with a higher stepping off point, clearly. And I think you've got a reasonable triangulation on the stepping off point from earlier in the call. Another way of looking at it would be to develop from Markus' volume number something which would give me in EBITDA terms around about EUR 200 million of EBITDA positive growth. Cost savings rolling through from our program net of inflation around about EUR 50 million. I think, you got to remember there's going to be a FX component in there of about EUR 150 million would be my guess based upon the translation effect. That's a minus, of course. And then there will be some things flying around in terms of special items. And of course, the sort of what I think of as a half a year of TDI fly-up. I think that's probably the other important component you're going to see a continuation of the fly-up margins on TDI for about 2 quarters more next year, based upon what I can see in the market at the moment. And then we might return to slightly more normal TDI margins for the rest. So that would imply sort of EUR 250 million of pricing delta minus, if you like taking it back down the second half. Does



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that help? That's how I'm thinking about it anyway and I'm in the middle of the arguments with the business units about budgets at the moment. So it's always a healthy way to have my back of the envelope version.

Thomas Swoboda - *Societe Generale Cross Asset Research - Research Analyst*

This is very helpful and more than I have expected.

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

Just wanted to ask 2 quick questions. One was obviously BASF is having some problems with the new TDI plant with dichlorobenzene pollution. Are you seeing any benefit from that in terms of the demand in Europe and for TDI? And secondly, you've obviously got a target of net debt-to-EBITDA of 1.5x. Certainly, in my numbers once you've spent the EUR 1.5 billion on the buyback you won't even be above 0.5x net debt-to-EBITDA. I just wondered how much do you feel you need to hold back of leverage for potential M&A going forward. And obviously, by implication, how much more could you buyback? And then thirdly, just quickly, Patrick, just on the comments very helpfully made about 2018, just to follow through the numbers, are you suggesting that the gap is either EUR 400 million to VARA, but from a higher stepping off point or we could even be flat on 2018 EBITDA versus 2017. So it sort of a gap somewhere between those 2 numbers.

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

Well, Geoff, this is Markus. Talking for your first question on TDI. I would give it a shot and then Patrick will go for the second and the third part of your question. So with the particular event on the problems as you have named it from one of the market participants, we do not see any additional effect to give a very short answer. I hope that helps.

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

Geoff, it's Patrick. Yes, 1.5x is indeed the target. And as you correctly calculate, based upon our free operating cash flow, it is unlikely we will reach that just yet. The way I'm looking at it at the moment is that in the current environment where M&A seems to be highly inflated in our sector, if I look at the sort of prices that are being paid, I really struggle to see where value is being created. Therefore, I would think that we would renew our 10% target at the next shareholders meeting. And we would probably be looking at a similar situation going forward. But that may of course change. And if the right deal comes along, then that's fine. But to be honest, having looked at a lot of the examples that we were quite interested in, none of them are actually value creating for us at the current multiples. There's some crazy valuations going on at the moment and because money is relatively cheap, people are going for it, but of course that doesn't create value. And my mantra on M&A is it has to create real value. And unless it does, we won't do any. Finally, just a retake on what I was suggesting. I wouldn't think of next year being flat with this year quite simply because there is at least EUR 300 million of fly-up that's different. Yes, I think, if you look at that, there's EUR 250 million to EUR 300 million of fly-up that we're not going to have next year. If all the assets come on as we expect them in TDI. I mean, we did say that at the beginning of last year, I do know. But we're saying it again, because I cannot believe that these assets will not function eventually. Does that help?

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

Yes, that's fine.

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

Thanks, Geoff. Thank you. So back to you, Ronald.



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Ronald Koehler - *Covestro Aktiengesellschaft - Head of IR*

Good. So thank you all for listening and all for your interesting questions. And we will latest talk with the Q4 results in February. But in between, we might have the one or other opportunity to see each other. And for that, thank you and goodbye.

Operator

Ladies and gentlemen, this concludes the Investor Conference Call of Covestro. Thank you for participating. You may now disconnect.

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