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Q3 2019 Covestro AG Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Covestro Investor Conference Call on the Q3 2019 results. The company is represented by Markus Steilemann, CEO; Thomas Toepfer, CFO; and Ronald Koehler, Investor Relations. (Operator Instructions) I'd now like to turn the conference over to Ronald Koehler. Please go ahead, sir.

Ronald Koehler *Covestro AG - Head of IR*

Yes. Good afternoon, and welcome to our third quarter conference call. For your information, we have posted our interim report and the conference call presentation on our website, and we assume you have read our safe harbor statement. I would now like to turn it over to Markus.

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

Good afternoon to our European listeners and good morning to our U.S. investors. Prior to presenting our third quarter results, I would like to share our highlights from the K fair, which demonstrates very well our long-term aspirations. Every third year, the Düsseldorf trade fair opens its doors for the top global trade fair of the plastics industry. It took place just last week. Three topics formed the center of our booth: Circular economy, digitalization and innovation.

First, we commit to circular economy. Megatrends such as climate protection and population growth require a fundamental rethink in lifestyle and consumer behavior, as well as in global production. We need a complete transition from a throwaway to a circular economy in order to handle limited resources more responsibly and protect the climate. Covestro is committed to establishing new material cycles throughout the entire process chain over the next years and decades.

Second, digitalization. This is another driving force for the development of the economy and society in the coming years. Covestro will exploit the resulting opportunities and is embedding digital technologies and processes from this supply chain through to production, research and all interfaces to customers and to the development of new business models.

Third, the dedication of Covestro to innovation. The highlight exhibit was an interior concept for future mobility that Covestro developed together with partners along the automotive value chain. Trends such as autonomous driving, electric drive systems and car sharing turn the car into a multifunctional mobile living and working space. The main features are newly designed surfaces that allow 5G communication, the integration of ambient light, the latest infotainment systems and forward-looking seating concepts.

Turning to Page #3. The third quarter developed in line with our expectations. The year-on-year comparison continues to look weak. However, we delivered the predicted acceleration in core volume growth and a solid cash flow generation.



We achieved a strong core volume growth of 5.3% this quarter. Such growth demonstrates our capability to compensate declining automotive industry and withstand a weak macroeconomic environment. Our EBITDA decreased significantly year-over-year. However, with EUR 425 million, it was fully in line with our guidance.

On the cash side, the management actions taken to optimize working capital showed positive effects. Thus, we could achieve a solid free operating cash flow of EUR 243 million in Q3.

With only November and December ahead of us, we're narrowing our full year 2019 guidance within the public ranges.

If we now turn to Page #4, let me provide some more insight into our core volumes development by regions and industries in the third quarter 2019.

Overall, demand stayed depressed and the economic environment continues to be characterized by several uncertainties such as the U.S.-China trade conflict, tensions in Middle East and Brexit. Still, based on better product availability and helped by easier comparables, we managed to grow core volumes in every region. Asia Pacific was the best growth region this quarter posting 9% core volume growth, with China even growing double-digit. Several industries also showed double-digit growth rates in Asia Pacific like construction, electronics, wood/furniture and medical. Automotive demand remained depressed.

Europe, Middle East Latin America too, and especially Germany, suffered from the continuous weak demand in automotive. Double-digit volume growth rate in wood/furniture and electronics more than compensated development and enabled us to achieve a positive growth of 4%. NAFTA, and the U.S. in particular, also suffered from a weak automotive industry on top of a sluggish demand in electronics. Strong growth rates in construction combined with solid growth in wood/furniture and diverse other industries were able to counterbalance the weak spots. As a result, we achieved a positive growth of 2% for the quarter.

Overall, we're satisfied to see that our diversification across industries and regions helps to counteract the current weakness in the automotive industry and allows us to manage a challenging demand environment.

I now hand over to Thomas for the full set of financials.

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

Yes. Thank you, Markus, and also very warm welcome from my side.

If you please go to Page 5, you see the sales bridge for the quarter. And as you can see, we posted a sales decline of 14.6% in Q3 and the main drivers were deteriorating prices in MDI, TDI and PCS, reducing our sales by a total of EUR 686 million.

On the other hand, we delivered a positive volume growth contribution of EUR 80 million and also you can see in the bridge that FX effects added EUR 70 million, mainly attributable to the U.S. dollar and also to the Chinese Yuan.

So with that, let's turn to Page 6 for the EBITDA bridge. As you can see, we achieved an EBITDA of EUR 425 million for Q3, in line with our guidance. And also as forecasted, the higher competitive pressure in polyurethanes and polycarbonates led to a continued decline in contribution margin so that the negative pricing delta amounted to a negative EUR 537 million and you can find this also in the bridge.

On the other hand, the positive volume development was translated into an EBITDA contribution of EUR 42 million, thanks to a volume leverage of 53% and FX also had a small positive effect, as you can see in the bridge.

Finally, with respect to the other items, the main contributors were the lower costs driven by lower bonus provisions and the progress that we made with our perspective cost-cutting program, and on top, we benefited from a positive effect of EUR 29 million, which comes from the adoption of IFRS 16 and the adoption of the accounting standards, and we have been pretty transparent about the effect that is recurring every quarter.

So with that, let's turn to Page 7, and the highlight of this chart is the strong volume growth of 5.3%, which you can see on the upper half of the page. Overall, however, the macroeconomic environment has not improved. So strong price and margin pressure remains. However, we achieved a strong volume increase, which we believe was a good result given the current demand weakness.

If you look at the lower part of the page, you'll see that sequentially the EBITDA margin declined from 14.3% to 13.4%, which we consider a solid development within the currently very difficult industry environment.

And with that, I would like to hand it back to Markus for the segment details.

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Turning to Page #8, looking at our Polyurethanes segment on Chart #8: In Q3, we recorded a strong core volume growth driven by all 3 product groups. Overall, industry utilization stays at a low level due to additional capacities added during the last 15 months. Based on most recent data, industry demand growth remains solid at our predicted long-term trend of around 4% to 5%.

In MDI, the picture remains unchanged for this year. Few selected ramp-ups, but no new start-up leading to a slightly lower average industry utilization estimated at around 87% in full year 2019 versus 88% in 2018. Due to the currently low visibility on demand, we stay cautious about the further development in the short term. Midterm, we expect that current overcapacities will be absorbed by growing market demand. The recent cancellation of one new 400kt U.S. project for 2021 contributes to this view. For 2020, the only announced start-up is our MDI facility in Brunsbüttel, Germany, with a 200kt name plate capacity.

In TDI, the latest ramp-ups of 3 world-scale plants have increased supply pressure and continue to lower average industry utilization from a tight 85% in 2018 to around 76% in 2019. Of the roundabout 1 million tons of additional capacity expected between 2018 and 2023, 800,000 tons have already been started up and partly or fully ramped up. From current margin levels, we see limited further downside risk as we believe that high-cost producers are currently operating at or below cash breakeven levels. Potential upside would, for example, come from closures of high-cost plants, as seen in the past.

Finally, margins in polyether polyols continue to be below the long-term average.

Overall, the EBITDA margin of 13.3% in PUR in the third quarter 2019 was clearly below last year's level, primarily driven by significantly lower MDI and TDI margins. Taking a quarter-on-quarter perspective, the improvement reflects higher volumes and lower internal costs, thanks to undisrupted operations.

Let's turn to Page #9. In Polycarbonates, we recorded a strong core volume growth of 9.3% in the third quarter. The ongoing demand weakness in automotive could be compensated by double-digit volume increases in construction, electronics, medical and other smaller industries. Thanks to our position as cash cost leader in the industry, we have some flexibility to switch sales from one application and industry to the other, thus helping us to counteract any short-term weakness in one industry.

Prices were clearly below previous year after price declines continued in all regions, mainly in the commodity businesses. Consequently, net sales decreased by 13.2% year-on-year. The EBITDA margin came in significantly below previous year's level, impacted by the negative pricing delta. In a quarter-on-quarter comparison, the segment margin decreased due to continuing price pressure.

Let us take a short look at the overall industry prospects. Automotive represents more than 20% of the global polycarbonates demand and roughly 1/3 of our volumes. Given the declining OEM production coupled with a massive destocking in the whole automotive value chain, the overall polycarbonate market growth will be relatively low this year. On the other hand, we expect capacity additions of around 5% to 6% this year. More than 10% additional capacities have been announced for next year. This is expected to lead to a further declining industry utilization. We assume an ongoing mix deterioration. This said, we're preparing ourselves for several more quarters of declining earnings. However, as the clear market innovation and cost leader, we should be able to outperform the industry. Over the cycle, we're convinced that polycarbonates remains a highly profitable business for us with an attractive growth profile.

Let's turn to Chart #10. The impact from globally weaker demand continued to hit our Coatings, Adhesives, Specialties segment. Core

volumes declined in almost all customer industries, thus we recorded a negative core volume growth of 4.0% in the third quarter. In consequence, net sales declined by 3.0% year-on-year. Positive effects from currency and the portfolio impact from the DCP acquisition could not fully compensate the volume loss and weaker pricing this quarter.

EBITDA suffered from the negative volume leverage and margin pressure. In the first 9 months, we reported a core volume decline of 2.7%. We assume that we will return to positive core volume growth during the fourth quarter 2019. However, it is unlikely that this can compensate the year-to-date weakness. Therefore, we now expect a low single-digit core volume decline for the full year 2019.

We do not expect a fast recovery of the coatings and adhesives markets over the next quarters. In addition, a tougher competitive environment could further increase the pressure on prices.

Thomas will now explain more financial details.

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

Yes, thank you. Let's go to Page 11 where you see the free operating cash flow development, and I think it's pretty clear that the lower EBITDA, the higher CapEx and EUR 350 million cash out for our financial year 2018 bonus payment continue to be the main influencers of our free operating cash flow generation this year. However, as you can also see the free operating cash flow improved significantly during Q3, as we digested the negative phasing effects already in the first half of 2019, and additionally effective countermeasures reduced our working capital, thus we were able to generate a positive free operating cash flow of EUR 243 million in Q3, leading to EUR 143 million free operating cash flow for the first 9 months of this year.

So beginning of this year, we initiated a working capital optimization program, which yields the expected benefits, and already during the first 9 months of the year, we were able to limit the seasonal increase of the working capital so that for the full year 2019 we expect a triple-digit million euro positive contribution from changes in working capital to our free operating cash flow so that, overall, we see ourselves on track to deliver a free operating cash flow within our guidance range. And based on the narrow EBITDA guidance, we're also narrowing the free operating cash flow guidance to a range between EUR 300 million and EUR 500 million for the year.

So with that, let's turn the page to Page 12 where you can see the net debt development. As you can see, our total net debt level increased to EUR 3.4 billion at the end of September of this year, and the main increases are attributable to the payment of the dividends, as you can see in the chart, which we did end of April, as you see the adoption of IFRS 16 accounting standards which had an effect of EUR 649 million and, obviously, there was an increase in our pension provisions of EUR 574 million, as you all see these items in the bridge. And the increase in pension provisions came because of the decrease of a discount rate in Germany.

So in combination with a lower EBITDA, these developments led to an increased ratio of total net debt to EBITDA of 2.1x at the end of September. However, since the main deviations in total net debt have been triggered by accounting items, we continue to regard our balance sheet as being very solid.

And with that, let's come to the guidance, which you have on Chart 13. So overall, let me say that we confirm our guidance for 2019, but we narrow the guidance for our key KPIs within the published ranges.

Although we recorded a solid volume catch-up in quarter 3, we continue to face weak overall demand on the back of an uncertain macroeconomic environment and, therefore, we now assume a low single-digit core volume growth for the full year. As explained on the previous charts, we're also narrowing the initial free operating cash flow guidance, expecting to deliver between EUR 300 million and EUR 500 million. And accordingly, we also narrow the range for the expected ROCE to 8% to 10% for the full year.

Furthermore, as you can see on the page, we're expecting increase of D&A to around EUR 770 million triggered by an additional EUR 21 million impairment linked to the disposal of the European polycarbonates sheets business in Q3. We expect an improving financial result of minus EUR 80 million to EUR 100 million on the back of less negative hedging effects, and we're increasing our guidance for the tax rates to between 26% and 28%. The main reason for this increase is a one-time taxation of an internal dividend payment from our Chinese legal entity so that we assume that the previously guided tax range of between 24% and 26% is still a valid assumption for the

coming years.

So with respect to EBITDA, we also confirm the initial EBITDA guidance for the full year and we narrow the expected range to EUR 1.57 billion to EUR 1.65 billion for 2019, and this full year guidance implies an EBITDA range of between EUR 244 million and EUR 324 million for Q4 2019 so that compared to Q4 2018, we assume further price deterioration only partly being counterbalanced by lower raw material prices. Strict cost discipline and some volume growth should allow us to mitigate the resulting negative pricing delta.

So if we look ahead, we can say that during 2019, we suffered from continuing price decline for our products, but this is expected to give us a rather low starting point in December 2019 for the year 2020. So from today's perspective and based on a mark-to-market assessment, we would expect a low triple-digit million euro burden from a negative pricing delta for 2020. And as a consequence, we're preparing for another challenging year next year, which will be ahead of us.

So with that, back to Markus for the summary.

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Yes. Thanks Thomas, and now we're switching to Page #14. The third quarter developed in line with our expectations. We achieved strong volume growth in a challenging economic environment. The diversification of our sales towards several customer industries and the capability to switch volumes rapidly from one industry to another, thanks to our cost-leader position, enabled us to counteract the automotive industry weakness.

Our EBITDA came in as expected. Thanks to our strict cost discipline, we faced only a slight further decline of earnings in Q3 compared to Q2. In Q3, we again demonstrated our capability to manage working capital. This compensated a negative cash phasing effects from first half and ensured that we could remain on track to deliver on the full year guidance.

In light of the first 9 months results, we have narrowed our guidance for the full year within the published ranges.

Overall, we currently operate in very challenging markets characterized by oversupply due to increased capacities and simultaneously weakening demand. As a consequence, our earnings in 2019 remained significantly below midcycle levels.

Finally, we used the K fair last week to demonstrate our commitment to circular economy, dedication to digitalization and continued efforts in innovation to drive growth.

With that, we would like to thank you for your attention and are happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And the first question comes from Mr. Christian Faltz, calling from Kepler Cheuvreux.

Christian Faltz Kepler Cheuvreux, Research Division - Equity Analyst

Couple of questions, if I may. First of all, standard question. Can you talk about current demand trends, i.e., how has October started and what are your order books for your key industries suggesting at present?

Second question, in last year's Q3 call, you told us about some of your customers relocating production outside of China to avoid trade tariffs. Is that a process, which is concluded now and has this actually been to your benefit?

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Christian, this is Markus speaking. So looking at the Q4 order books/the October order books, and we're almost through to October, I think we're, with regard to the order books, in line what we would expect was the given guidance for the full year. That's how we'd comment that so we do not see anything that would significantly positively or negatively deviate in terms of the order books from what

we have given as a guidance for the full year or what we would expect for the fourth quarter.

With regard to the second question you asked and spoke about companies relocating outside of China, is this completed now? I would say, we just see, yes, these trends because we're talking about supply chains, relocation of assets just continuing, because that is not something that is happening in months. Sometimes you can simply because companies are switching business, so one company loses business, other company is taking it up. But if company is really relocating, that is a longer term process, and in that context, I would expect that this trend also mid-to-long term would continue because currently we do not see any signs that the trade conflict between U.S. and China will be sorted out short term, maybe not even midterm, and my personal opinion is also maybe not even long term. So I think this will be a continued trend. Do we benefit from it? I mean, you can see that with the strong volume growth, which was not only based on the comparison quarter from last year, but also clearly due to our leading cost position, has, from our view, benefited Covestro and whether this is related to the relocation of assets of our customers, I would say partially yes because compared to some other competitors, we have the ability to globally deliver and we have regionally well-established supply chains, and so I would say, without having any real hard data that specifically would target to that point, yes we have benefited from it.

Operator

The next question comes from Thomas Swoboda, calling from Societe Generale.

Thomas Swoboda Societe Generale Cross Asset Research - Research Analyst

I have 3. First, the on-capacity utilization at Covestro. Is it fair to assume that your capacity utilization was higher, especially in polycarbonates and also in polyurethanes, than the numbers you have provided us for the market globally. So that was the first question.

The second question is on the margin development in polyurethanes compared to polycarbonates. You have said in your prepared remarks you expect polycarbonates margin to further deteriorate. Historically, polycarbonates was less profitable than polyurethanes. However, it was vis-à-vis the last couple of years. Are we going back to the historic ranges where polyurethanes are more profitable than polycarbonate?

And lastly, the third question, on supply demand in polycarbonates, my question is, have you seen your competitors actively reducing capacity, canceling the build-out plans or strategically delaying start-up dates and so on?

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Thomas, thanks for the question. This is Markus speaking. So on capacity utilization, very short and briefly, I would say, we, as Covestro, should have better capacity utilization than what you see on average of the industry and the main reason for that is not only I think our very strong market access and customer centricity, but particularly cost leadership in the commodity area. And we outlined this earlier in our comments given during the presentation that this also enables us to still produce this positive margin contribution when some of the high-cost producers already getting cash negative when producing. So having said that, we clearly assume that we are having better utilization than the rest of the market. Another evidence for that is we are fully loaded. So our capacities are fully loaded. We sell everything that we can sell in polycarbonates and polyurethanes. Our assets are fully available, so we do not have any major planned or unplanned shutdowns, and that also has helped us to achieve the strong volume growth in polycarbonates and in polyurethanes in the third quarter.

On the second part of the margins with regard to profitability, I would say that the margins for polycarbonates would continue to remain under pressure simply due to the fact that we have had additional entrance and entries in the market in 2019. We said that earlier between 5% and 6% additional capacity, while at the same time, one major outlet for polycarbonates, which is the automotive industry, is in a significant downturn with regard to overall demand and that shifts also volumes into the commodity segment, which even further increases the pricing pressure. And we do not expect that this pricing pressure, in particular, in the commodity segment, will end soon simply due to the fact that, first, there is no additional demand, short term, maybe midterm for the automotive industry foreseeable, and secondly, we see additional capacity announced for next year in the range of additional 10%, again announced, that does not mean that it comes to fruition, but that is what we see.

On polyurethanes, I think and we have tried to explain that a little bit earlier that on TDI, we see limited further opportunities for prices to



decline and margins to get under even further pressure because some of the high-cost producers already most likely ceased production and cannot compete anymore. Similar is with MDI and in this context you also asked about how do we see the opportunity of polycarbonates profitability, maybe historically, go back, let's say, below polyurethanes profitability. It is very difficult to predict, but let me remind you of one fact. We have, since this has happened last time, significantly moved the product mix strategically to products with higher margins and where the volatility of those margins is lower. That's #1. We have significantly worked on our cost position. And thirdly, the last time when you have seen margins deteriorating that much, we also were not fully loading our assets. So all these 3 factors from my perspective would positively support, let's say, a margin development even under very difficult circumstances for polycarbonates.

So on your last third question, particularly polycarbonates supply demand and competitors canceling capacities or delaying start-ups on purpose, we have not heard about major or smaller polycarbonates player announcing cancelation of capacities. However, we have seen already in recent months so-called strategic reviews including all options from some larger players, for example, a larger European player who has put all options on the plate for its German-based asset. And in addition, we also have seen delays of ramp-up at least, and we don't know exactly for what reason, from one Chinese competitor. And if you look at the overall capacity addition in 2019, the announcement for overall capacity addition was way higher than what we had practically seen. I think it was double the rate, if I'm not totally mistaken. If you would have taken all unconstrained announcement, it would have been 12%, and we only have seen 5% to 6%, so that gives you maybe also a complete picture.

Operator

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

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

Three questions from my side as well. Coming back on the order book visibility, has the visibility changed in the order backlog? Or is it still as long as it has been during the last months? That would be my first question.

My second question is, you've already indicated on the EBITDA guidance for next year or at least on the pricing delta. If you would do a free operating cash flow bridge, the net working capital inflow, I suppose, should be year-over-year lower in 2020, but CapEx spending is higher. And also earnings, at least from this pricing delta, indicate the lower. So is it fair to assume that 2020 free operating cash flow should be most likely lower year-over-year.

And then last level is on inventories at your customers. Do you have any feeling or any idea or clue where the levels are compared to the start of this automotive weakness?

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Markus, this is Markus speaking. Thanks for your questions. I will provide you with an answer on the first one and Thomas definitely on the second one, and the third one, we're still sorting it out. No, joke aside, that will also be done by Thomas.

So on the first one, I think the order book visibility, in principle, is as usual. We have limited visibility about 6 to 8 weeks, but we have to, let's say, take into consideration some special effects. So as I said, general direction, there's no significant difference. However, there is smaller orders coming in. So customers really ordering hand-to-mouth just what they need on short notice. In some areas, the other topic is that we, for example, in polycarbonates, slightly shifted the portfolio due to technical reasons and to load our assets a little bit more into the commodity area, and there you have normally different buying patterns compared to the more specialized area. So these reasons lead to a slightly different order book visibility, but not if you really compare apples-to-apples, then more or less it has stayed the same. With that, I'd like to hand over to Thomas.

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

Yes, I think your question was, how is free operating cash flow developing? So let me maybe start with EBITDA first and give a little bit more structure to the building blocks that I think you guys should consider. However, I would also clearly say this is not to guidance, this is way too early for this, but just to give a little bit more structure and clarity on some of the building blocks that we currently see. So first of all, we indicated to you that in terms of EBITDA, we do see a negative pricing delta and we said it could be a low triple-digit number

that you should plug in here. On the other hand, we always said that on the volume side, we would expect a positive effect on EBITDA from the volume. And again, I would attach a low triple-digit positive number to this. FX, difficult to say, but I think, to take something like a neutral effect would be probably not totally wrong. And then on the other bucket, I'd probably attach a negative number to this simply because driven by our higher CapEx, we're also facing higher costs in order to get this CapEx into the ground. So I think that if you take this together, again too early to give a guidance, but 2 negatives, one positive, nobody should totally exclude the case that the EBITDA might be below the 2019 number next year.

From that into cash flow, I think you named some of the buckets. I would say, CapEx, we're expecting a higher number. The working capital positive contribution is probably lower simply because we have already significantly or will have improved our level this year. On the other hand, there will be some relief from the bonus payment where we had to digest EUR 350 million from 2018 as a cash out this year and the same is true for the tax where we had some higher cash tax payment this year, which will obviously not reoccur next year. Again, 2 positives, 2 negatives on the back of a potentially lower EBITDA, nobody should be surprised if the cash flow in 2020 could also be a lower number. Again, I'm repeating myself, this is not a guidance, this is more what are the structures of the building blocks that you guys should consider.

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

Okay, understood.

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

So maybe on your last question in terms of customer inventory levels, in particular, I assume or -- no, I recall you were referring to automotive. Destocking from our perspective might continue into the fourth quarter. However, we expect that it will be a little bit better in Q1, but there's still very, very high uncertainties. The [direct] inventories, also given the chemical nature of the respective raw materials, in MDI and TDI are normal. There might be still slightly higher volumes in polycarbonates, but also here, handle this with care because some of the grades are highly specific, particularly also in the automotive industry, and you might have some sitting on stocks, but you cannot use them for any other purposes. So even though there might be inventories, you still might need to order special grades. Whereas in the commodity area, we do not assume that there is high inventories actually on stock ordered, for example, traders carry a lot of those inventories that should be through meanwhile.

I hope that helps.

Operator

The next question comes from Sebastian Bray. He's calling from Berenberg Bank.

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

I would have, 2, please. The first is on the assumed negative pricing delta of a low-digit million euro some at EBITDA. Could you please give an indication of how this is split between CAS and Polycarbonates, and in particular, an overview of capacity utilization or at least the competitive outlook in CAS. I know we don't usually talk about utilization of the segments, but is the competitive situation becoming tougher? That's my first question.

And my second question is on the impact of higher pension provisions on the P&L for next year. It looks as if by the end of the year, you will have EUR 600 million, EUR 700 million pension liability. Could you please remind us of the implied additional P&L cost that you have to foot as a result of this?

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

Yes. With respect to the first one, so again, we said we're expecting a negative, but low triple-digit negative pricing delta for 2020 relative to 2019 if you take what we expect as the starting point in terms of prices end of this year. Now your question was how to split this. I would say, it will mainly come from PCS and to some extent also from CAS, but the major portion is PCS, which is reflected in here.

And then, your second question, yes, we have higher pension provisions on the balance sheet because of the lower discount rate. The impact on our P&L for next year is negligible, I would say. And I would also remind you that the cash effect of this is negligible. We're

paying a very constant cash out on pensions of roughly EUR 25 million every year and that is pretty much independent, at least in the short term, of how big the provision on the balance sheet is. So I would say on both ends, no major effects to be expected next year.

Operator

The next question comes from Jean-Baptiste Rolland. He is calling from Bank of America Merrill Lynch.

Jean-Baptiste Rolland BofA Merrill Lynch, Research Division - Associate

I have 1, please. You mentioned capacity additions of 10% next year in polycarbonates. I'm just wondering how much do you bake in terms of capacity additions for the years beyond? How much do you also expect for growth in polycarbonates demand in 2020? And second question to that is how -- when you say that you believe that the midterm outlook for polycarbonates remains sound, how long do you think midterm is really?

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

This is Markus speaking. So thanks for your question. So talking about capacity additions of 10%, again, that is announced capacity. Please always handle this with care because you have seen already this year, as outlined earlier, that announced capacity addition and real capacity addition must not necessarily be the same number. Normally they're little bit lower. However, 10% is what we take as a planning assumption. And if you now would, let's say, move ahead in the next couple of years, currently what has been announced is for 2021, 11%, and for 2022, something around 14%. And to put this into perspective, all of those capacity additions are currently announced for China and all of those capacity additions coming from Chinese players. And in this context, it is always important to understand that this has been encouraged by the respective government as this was one of the strategic polymers that the Chinese government wanted to see local self-sufficiency, but we also have to be clear in this context that this encouragement and respective policies have been withdrawn meanwhile. So also this is part of the overall picture in this context.

Midterm remains sound for PCS. How long will this be you asked. We normally plan for 5 years. So -- and if we talk about 5 years, between 4% and 5% growth of polycarbonates is what we assume. I hope that helps.

Operator

The next question comes from Georgina Iwamoto, calling from Goldman Sachs.

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

I've got 2. The first one is on kind of the volume outlook for next year. You've got a clear strategy to fully utilize your plants as far as possible. I just wanted and see if you could confirm what kind of capacity you expect to have to grow into for 2020?

And then my second question is on polycarbonates. You set out some helpful expectations for further weakening of mix over the next few quarters, and you've previously disclosed about 60% of sales in polycarbonates is resilient. Can you give us an idea of where that figure is today and where you see that heading to in the next few quarters?

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

This is Markus speaking. Thanks for your questions. So the volume outlook should be around 4%, also let's say, on the average that we planned for. And for example, 200,000 tons of capacity in MDI coming on stream next year. And so if we also assume for the rest of the portfolio, also due to a different turnaround pattern and things like that because many of the larger turnarounds have happened actually within this year, particularly in the first half, we would think that we have enough for 4% growth if there will be no outages of our plants. So considering this, 4% is what we would think would be achievable within next year.

Now coming to the second question, polycarbonates. We still intend strategically to grow the share of the resilient portfolio, and yes, it was around 60%. However, this year, it is clear, also due to the short-term tactics to load our assets and to compensate for the losses in the automotive industry, that we would lose parts of this share tactically within this year and if things are continuing that also might lead in the next quarters to further tactical losses and a shift therefore of the respective parts that are resilient versus the parts that are commodity or nonresilient. Midterm, however, there is a few trends that would continue to help recovery of the automotive industry, 5G, medical application. So there is a couple of things that we have in our plate why we believe that once we are through this very



challenging environment and things are either recovering or coming through in terms of growth and significant growth and volume contribution to the portfolio that we'll go back to the 60% plus and beyond for the polycarbonates portfolio. I hope that helps.

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

Yes. It does help about, but I do have 1 follow-up on that. And if you do have kind of auto recovery, would you expect those auto OEM-related volumes to come back in at the same margin as we've seen in 2018? Or are the auto OEM customers likely to negotiate a bit harder this time?

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

Well, what is clear and we have to try to outline that there is some relationship, let's say, about overall length of the nondifferentiated or commoditized market margins and prices somehow into the more resilient part of the business. However, the resilient part of the business has much less volatility and also on average definitely higher margins. So would we go exactly back to the level of 2018 once we see a first recovery? No. Are those margins totally out of reach mid to long term? Also no. I mean, that is the true picture because we currently are in a situation where we have long markets where we see, also for the next quarters, that there is more pressure coming on the polycarbonates commodity area and that will also have some impact on the specialized grades. But midterm, again, once things are back to normal, I think we can also see very healthy margins in the automotive segment again.

Operator

The next question comes from Isha Sharma, who is calling from MainFirst.

Isha Sharma *MainFirst Bank AG, Research Division - Analyst*

I have 3, please. You mentioned that the high group volumes were head by better availability. Is it also the case for polycarbonates with such a sharp increase that we have seen in Q3? Or do you see just stronger end-market trends compared to the first half? That would be the first.

Secondly, could you please put some more color on the volume decline that we have seen at CAS? Which end-markets show weakness and how should we think of this going into 2020?

The last one would be again the pricing guidance, at least for 2020. You mentioned that you will see increased pressure in polycarbonates as well as CAS, but how should we imagine this for polyurethanes? Do you expect a significant recovery or more like a flattish development?

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

Isha, thanks for your questions. This is Markus speaking. So looking into your first question, the story is similar actually for polycarbonates. So also in Polycarbonates, the availability was the main driver, it was not the demand. As we outlined the demand, in particular for polycarbonates in the automotive industry, and also the exposure towards the automotive industry in polycarbonates is higher than in the rest of the portfolio. So that means it's not demand driven, but simply our own supply capabilities that have improved due to the major plant turnarounds have been finished in the first half, and since Q3, we were able to continue to fully push volumes out of the plants, which we then did, and it also helped us to fully utilize and get the respective volume leverage.

On your second question that was the volume decline in the Coatings, Adhesives and Specialties arena, for the markets we're talking about is particularly automotive, but also the industrial coatings area. These are the 2 major end users where we saw a decline in the respective applications and we do currently not see that this trend will be short-term turnaround because we do not see any strong signals or even weak signals that would indicate that this would short term recover and that may also be true for some more quarters as far as we look at the Coatings, Adhesives, Specialties areas. And the good thing about the specialties business is that it is special and a bad thing about it is that it is a special business, so it is very difficult to switch from one application and push one materials into others likely, for example, do it for polycarbonates. So on the pricing guidance, I would like to hand over to Thomas.

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

Yes, Isha. I mean, just to be very clear, what we said is if we take the expected pricing level for December, which we expect as of today, and then do a mark-to-market into 2020, we said this would then probably be a low triple-digit negative pricing delta that this would generate in 2020 relative to 2019, taking the expected starting points of end of December of this year, and that negative pricing delta will mainly come or will mainly concern PCS, to some extent CAS, and to a lesser extent PUR.

Operator

The next question comes from Geoffrey Haire. He's calling from UBS.

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

I've just got 1 left. Can you just help us understand will you have any start-up costs relating to the Brunsbüttel plant in either Q4 or the first few quarters of next year? And if you do, could you just maybe give us some guidance to what those would be?

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

We're expecting Brunsbüttel to start up at the beginning of next year, if everything goes well. But I would say there is no specific high cost attached to this start-up and to the ramp-up or at least not to a degree that you would kind of be able to track and trace them in our overall group numbers and, therefore, I would say this is existing, but definitely a minor item overall.

Operator

The next question comes from Thomas Wrigglesworth, calling from Citi.

Thomas P Wrigglesworth Citigroup Inc, Research Division - Director and Chemicals and Basic Materials Analyst

Two questions from me. Firstly, on polyurethanes and polycarbonates. When we look at that volume, is that all market share or is actually the market share taking what you have executed larger than that because these end-markets actually declined, so wanted to get a sense of how much net market share you've taken in those 2 businesses?

Second question is, I think you've been talking now for 2 quarters about MDI prices being into the cost curve, is it surprising you how long it's taking competitors to adjust production? Do you think something's changed in the competitive landscape with -- in this cycle versus previous cycles? Any comments there would be very helpful.

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

Let me maybe start with the second question. So I would say the answer is no. We're not surprised. I think what we've been saying is, and we cited some industry journals which said that in MDI and also TDI, we were moving into the unhealthy space so that the high-cost producers were probably losing cash with every ton that they produce. We think this is true and this has led to, at least what we see, a stabilization in the MDI and TDI prices. So it looks like we have reached more or less a bottom here. But on the other hand, I think what we also said is, this does not change the picture from how long does it take the market to really grow into the capacity before prices start again, and also we know that it takes a long time before -- a longer time before competitors finally drop out of the market all completely and, therefore, I would say the development that we have seen is in line with our expectations, which is a kind of sideways movement in terms of prices for those 2 products.

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Yes, this is Markus speaking. So on your second question, in terms of market share, if you really look at the numbers for the first 9 months and it's always very difficult quarter-on-quarter, inventory levels or turnarounds, unplanned shutdowns, whatever. So there is a lot of additional complexity and this is why quarter-on-quarter comparisons are really difficult if not misleading. So let's take the first 9 months as an indication. We still see that the polyurethanes market is growing quite well and that is also reflected in some stabilization in the respective prices and we still again absorbing additional capacity from last year, which makes progress. So the market is growing at 4% to 5% and I would say for the first 9 months in PUR, we even slightly grew below the market if you look at the growth rates for polyurethanes. And for polycarbonates, there is still 2% to 3% market growth, which means that we are more or less at or slightly above market in terms of polycarbonates. So this is the picture how we look at it. So again, I would say we are developing within the market range, right? So -- does it help?

Operator

The next question comes from Chetan Udeshi, calling from JP Morgan.

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

Two questions. First on just midterm CapEx, which I'm assuming hasn't been changed. So can you maybe help us understand the bridge from the EUR 350 million or so of maintenance CapEx that you have per year to over EUR 1 billion CapEx that you guys have talked about in the past for 2020 and beyond? Like what are the different buckets that you are spending the money and it will be useful to know how much is going into different buckets as well?

The second question was, and I'm just reminding myself of the 3 KPIs that you guys had presented for short-term incentive planning. If I'm not wrong, 2 out of the 3 KPIs were, one on free cash flow over 400, the other was ROCE above WACC by 8% to get to 100%. Now clearly, this year, based on your guidance, those 2 and probably even the volume part might not be achieved next year. You're not ruling out a potential of decline in volume, so like what is the -- like -- flexibility you have to change any of these parameters? Or is it going to be the case that at some point this short-term incentive program will be changed to reflect challenging environment, so you will, to some extent, reduce the thresholds? Is that going to be the next sort of outcome?

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

Chetan, let me start with your last question. First of all, maybe this is a misunderstanding here, we didn't say that we were expecting volumes to decline next year. To the contrary, I said, you guys should expect a positive volume effect in your EBITDA bridge. What we said is there might be a negative pricing delta in the EBITDA bridge if you take the expected starting point December 2019 and to have used this as a mark-to-market into 2020. So again, just to be crystal clear, we're expecting volumes to be up and we're also expecting that this should have a positive effect on our EBITDA.

Now with respect to your question, our bonus system usually is set up for 3 years. You just said it, in order to achieve 100%, the threshold of 4% core volume growth, EUR 800 million free operating cash flow and 8 percentage points over WACC. And I think currently there is no intention to change that system. So I think your first question with respect to CapEx, our guidance for 2020 is EUR 1 billion to EUR 1.1 billion. Maintenance CapEx we always said is EUR 300 million to EUR 400 million to major projects. In there is our MDI 500 in the U.S., which is slowly getting costly because we're moving into the planning phase and especially the European activities in terms of our chlorine factory, our aniline factory in Antwerp and the related projects to this one. So I think Spain and Antwerp are the major projects that you find in the 2020 numbers.

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

Are you saying 2020 already includes sizable CapEx from MDI in the U.S.?

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

No, it's not a sizable CapEx because most of it -- I mean -- sorry, I mean to -- let me just correct myself. 2020 already includes costs for MDI 500, but you will find them in the OpEx line, mostly not in the CapEx line because we cannot yet expense it because we have not yet achieved the relevant milestone in terms of the pure CapEx, which is capitalized. The major numbers in 2020 will come from the European activities that I just named.

Operator

The last question for today comes from Jaideep Pandya, calling from Millenium.

Jaideep Pandya

Just on the U.S. MDI market. Can you just explain me in very simple terms why the profitability in U.S. remains to be very high compared to the other regions? And what is the sustainability of this when we think of the next 2, 3, 4 years when pretty much everyone wants to increase capacity in the U.S.?

And then the second question really is on China or rather what you're seeing in China where capacity increases, as you point out, are being pushed out into 2021, 2022, so do we think really here that even the big players are suffering and, therefore, doing this? Or is it just the balancing act between volumes, as you are saying, they need to grow into and utilization?

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Maybe on the first question you asked, first and foremost there is wrong numbers quoted by some consultants, to be very clear, because we do currently not see significant capacity additions, in particular in the next 2 to 3 years, and you might have seen that even one major announcement has been that there is at least withdrawal of a planned investment in a major investment. So -- and particularly U.S., MDI prices here are really wrongly quoted by some consultants, so that is very important that there is just an indication maybe on some trends, but the absolute levels are in most cases simply not correct. So that is I think very important to keep this into consideration. And then the -- there is also some cost issues if you look, for example, on tariffs for some of the raw material goods. Take aniline that you need to import from China into the U.S. There have been additional tariffs on these. So from that perspective, you might also consider that some of the supply chains that have been built and have been calculated into respective investments may simply lead to different calculations after the tariffs have been imposed and may not make the overall investments including other factors that you have to consider, as profitably looking as before, but that is a speculation because for sure we have no idea, let's say, how the cost calculations look like, but it's just an assumption that I would make. And therefore the cancellation of the respective MDI capacities from our perspective are not demand driven, but more driven by the respective cost developments. Does that help?

Jaideep Pandya

Yes. So in a nutshell, current U.S. profitability is better than the other regions, is that right? That's what I was trying to understand really to be honest.

Markus Steilemann Covestro AG - CEO & Chairman of Management Board

Yes. I would say -- yes, you could say so, but -- and it's not a major topic. So they are slightly better, really slightly better so to be very clear. For sure, you have an advantage when you're sitting in the country because the cost to serve, cost to deliver are lower than for local producers. But in general terms, I would say there is still import in the U.S. However, they have recent declines also due to the tariffs that have been imposed there. So yes, there is some margins, but again, the whole picture is short term, on short to midterm, there is no significant supply addition in the U.S. foreseeable, also due to the fact that somebody has withdrawn. And again, the margins, even if you would take the published numbers, are only slightly higher than in other regions, also due to the fact that some of the MDI prices are simply misstated.

Operator

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

Ronald Koehler Covestro AG - Head of IR

Good. Thank you very much for listening and all your interesting questions. If you have additional questions, don't hesitate and call the IR Department or we will see you during the quarter with our activities. See you then, bye-bye.

Operator

Ladies and gentlemen, this concludes the investor conference call of Covestro. Thank you for your participation. You may now disconnect.

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