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1COV.DE - Q1 2018 Covestro AG Earnings Call

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APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 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 Q1 2018 results. The company is represented by Markus Steilemann, CCO, Thomas Toepfer, CFO; and Ronald Koehler, Investor Relations. (Operator Instructions)

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

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**Ronald Koehler** - *Covestro AG - Head of IR*

Good afternoon, and welcome to our Q1 2018 conference call. With me on the call are Markus, our current CCO and CEO as of June 1; and for the first time, Thomas, who joined Covestro as CFO on April 1.

For your information, we've posted our Q1 interim statement and the conference call presentation on our website. We assume you have read our Safe Harbor statement.

I would now like to turn the conference over to Markus.

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

Good afternoon, everybody. The first quarter 2018 closed with a record quarterly EBITDA of more than EUR 1 billion. This excellent performance reflects the operational strength of our businesses. This puts us well on track to deliver our full year targets and is fully in line with our 2018 outlook as communicated with our full year 2017 results.

In quarter 1, we maintained core volumes on the high levels of the previous year. In tight industries with high utilization rates, we further improved our earnings with a strong year-on-year EBITDA increase of 26% to reach EUR 1,063 million. This led to an EPS of EUR 3.24, an increase of 40% versus



## APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

prior year quarter, and another strong free operating cash flow progressing by 73% year-on-year to reach EUR 364 million. Against the backdrop of a strong first quarter, we feel confident to fully confirm our full year 2018 guidance.

Before digging into the figures of this quarter, let me remind you of the high comparison basis of previous year's quarter. This is important to understand this quarter's development. We declared force majeure in polyurethanes in quarter 4 2016. Thus, quarter 1 2017 was characterized by a sell out of our complete production and inventories in order to satisfy the pent-up inquiries of our customers. Also in quarter 1 last year, core volume growth in polycarbonates was boosted by the new production lines in China that had come on stream only 3 quarters earlier. And finally, for quarter 1 2017, you will remember that we highlighted some pre-buying in our Coatings, Adhesives, Specialties segment, which accompanied the announcement in March for price increases in April.

With this in mind, we regard the sold core volumes in first quarter 2018 as a solid achievement. The weakness in demand from the construction industry was mainly caused by the harsh winter in the northern hemisphere. In general, we recorded a favorable industry sales mix with an increased share of higher value applications. We, again, achieved attractive growth in automotive with solid core volume growth in all regions and medical and diverse industries with double-digit growth rates.

Europe, Middle East, Latin America core volume development includes solid growth of Coatings, Adhesives, Specialties in Germany as well as double-digit growth of the group in Latin America. For the NAFTA region, we note the positive development of polyurethanes. And for APAC, polyurethanes in China and polycarbonates were the main drivers for growth.

I will now hand over to Thomas.

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### **Thomas Toepfer** - Covestro AG - Chief Financial Officer & Member of Management Board

Well, thank you very much, Markus, and good afternoon to everybody. It's a pleasure for me to be here for the first time, and of course, I'm very much looking forward to meeting everybody of you in person soon.

I'm on Page 5 of the presentation, where you see the sales bridge. And as you can see, our sales in the first quarter increased by 5.4% and that was driven by higher selling prices in all 3 segments. On the other hand, lower volumes had a negative sales effect of 1.7%, mainly driven by significantly lower non-core volumes. And finally, the FX headwind gained even more momentum in Q1, mitigating by half the positive pricing effects.

If you please turn the page to #6, you have the EBITDA bridge, and as you can see our EBITDA increase of 25.7% versus the prior year quarter was driven by a strongly positive pricing delta of EUR 390 million. And thanks to the continued tight situation in our industries, we passed on higher raw material prices in the Polyurethanes and Polycarbonate segment and increased our average selling prices even more. On the other hand, the FX headwind also burdened the EBITDA in Q1. And so as a reminder, we mainly produce our products where we also sell them. And therefore, we faced limited transactional FX risks, and almost everything that you see here on the page is translational in nature for us.

So with respect to other items, we faced higher operational costs for intensified maintenance activities and logistics due to a higher rate of interregional shipments. And please also note the fact that in the prior year quarter, we benefited from the release of a provision for our Tarragona site.

Please turn the page, I'm on Page 7. As you can see, in Q1, we increased both sales and earnings for Covestro Group, driven by the segments, Polyurethanes and Polycarbonates. And in terms of core volume growth, the solid development in PCS compensated the slight declines in polyurethanes and also in our Coatings, Adhesives and Specialties segment. So that the EBITDA margin improved from 23.6% to 28.1% in Q1. And as in the last quarters, let me put this a little bit into perspective. If you exclude the TDI fly-up margin that we have pointed your attention to several times. So if you exclude this, our margin would have been at around 23%. And that still represents a progression of 3 percentage points versus the prior year quarter, if you look at it from a like-for-like perspective. However, this 23% shows a level which we deem more appropriate to reflect this quarter's underlying performance.

So overall, we were able to increase our EBITDA each quarter versus the respective prior year in the last 13 quarters.

APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

And with that, I would like to hand it back to Markus.

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

Thanks, Thomas. We are now continuing on Page #8, and looking at our Polyurethanes segment.

The picture in the first quarter 2018 was similar to the situation we observed during the second half of last year. Generally, demand remained strong for polyurethanes. The industry broadly continued to operate at its limits, quickly absorbing added capacities. Still constrained by limited product availability, and on the back of a high previous year comparison basis, our core volumes slightly declined in the first quarter.

Temporarily, sluggish demand from the construction industry hampered by a cold winter in many parts of the northern hemisphere led to a reallocation of volumes. The major positive contributor for growth was a strong volume increase in the automotive industry.

In MDI, Chinese monthly contract prices for polymeric MDI were down, partly attributable to the weak demand in construction, partly to the well-flagged and expected capacity additions by competitors. Monomeric prices in China, on the other hand, held up well. MDI industry prices in other regions were up quarter-on-quarter in Q1 2018. In total, we recorded MDI margins almost on par with the high levels of fourth quarter 2017. For the full year 2018, we continue to expect our average MDI margin to be flat versus the average MDI margin in 2017. After one quarter with above-average margins, this expectation implies at least one quarter should be below average during the rest of this year.

For TDI, we again realized a contribution from fly-up margins of approximately EUR 200 million in first quarter 2018. We continue to assume that the TDI margins will normalize during 2018. Therefore, we expect, for the full year, a benefit of around EUR 250 million. However, visibility on that remains low.

Finally, we assume a slightly increasing margin in polyether polyols as our current margin is below the long-term average. This is expected to partly compensate the TDI development.

Continuing on Page #9 with the business unit, Polycarbonates. In Polycarbonates, we delivered a solid core volume growth of 2.7% in quarter 1. This is on top of the double-digit growth posted in the prior year quarter. Strong contributors for the growth were the automotive and electronics industries.

The EBITDA margin increased from 24.3% in first quarter 2017 to 29.3% in first quarter 2018. The margin increase was mainly driven by a strong pricing delta, supported by a positive volume leverage.

As commented on our full year conference call, we observed a negative pricing delta in the first half year 2017 due to higher raw material prices and could successfully catch up during the second half of last year. Thanks to the increased selling prices, this was, again, the case in first quarter 2018. We even realized the price increases in a more accentuated way, mainly due to price hikes for the commoditized grades, which were affected by the Chinese ban of scrap imports. This effect might be temporary in nature, and we continue to deemphasize this commoditized volatile part of the product portfolio. One strategic decision in this context was the announced divestment of our polycarbonate sheets business in the United States.

Another factor for short-term volatility may be the availability of announced capacity additions by Chinese competitors, most of them new players in the polycarbonates industry. Nevertheless, our overall industry outlook for polycarbonates based on global supply and demand remains very attractive.

In second quarter 2018, we plan a major maintenance shutdown at our Shanghai site. However, we expect to continue our volume growth and supply all customers from inventories. For the full year, we expect a continued path of margin improvement, based on the promising start to the year.

## APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

Continuing on Page #10. Before commenting on the performance of Coatings, Adhesives, Specialties, please note that as of this quarter, elastomers has been shifted from Polyurethanes to Coatings, Adhesives, and Specialties, and is now managed and reported in this segment. As a consequence, historic values have been restated. This shift diluted the EBITDA margin by around 1 percentage point. The contrary applies to the PUR segment. Due to the relative size, it is less visible, though. We posted the elastomers details in the appendix of the 2017 full year presentation as well as in the appendix of this presentation.

Coatings, Adhesives and Specialties core volumes slightly declined year-on-year. Taking into consideration the double-digit growth rate of the first quarter 2017 helped by prebuying, the sold volumes this quarter represent an encouraging start to the year.

EBITDA decreased by 15% year-on-year versus restated figures affected by a negative pricing delta. Although, we increased average selling prices year-on-year, they could not compensate the impact of higher raw material prices. We also consider the achieved EBITDA margin of 23%, now including elastomers, as a promising start to the year.

For the full year 2018, we expect improving volume growth momentum based on an improved environment. Consequently, we foresee positive year-on-year volume and earnings growth as of second quarter and for the rest of the year.

Thomas?

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### **Thomas Toepfer** - Covestro AG - Chief Financial Officer & Member of Management Board

Yes. I'm on Page 11, where you see the overview on our cash flow development. So in Q1, we were again able to generate a free operating cash flow of EUR 364 million in a seasonally low quarter. And the strong improvement was driven by the significant EBITDA increase. Overall, the free operating cash flow followed, therefore, the EBITDA development. But on the other hand, more intense working capital needs, higher CapEx and higher tax payments based on increased earnings reduced the number for the quarter.

So the overall higher working capital this quarter is driven by the usual seasonality. And additionally, the higher selling prices, again, led to higher values in inventories and increased receivables. The working capital to sales ratio reached 18.7%, and that's a similarly high rate as in the previous year quarter.

So in line with our full year 2018 outlook, we anticipate that the environment of an increasing group selling prices may come to an end during 2018. And therefore, the cash effect of working capital may turn favorable. So that for the full year 2018, we expect the working capital to sales ratio to be back within our target range, which we have specified with 15% to 17%.

If you look at capital expenditures and D&A, we reiterate our guidance that both items will be in balance for the full year 2018, and we have forecasted and guided CapEx to be in between EUR 600 million to EUR 650 million and D&A is expected at EUR 600 million to EUR 620 million.

The cash tax rate, if you look at that number in the first quarter, was disproportionately low. And therefore, due to some phasing effects in Q1, we expect a relatively high cash tax rate in the second quarter of 2018. However, I think it makes more sense to look at cash taxes more from a full year perspective. And if you do this, we expect a cash tax rate, which was slightly below the effective tax rate, and that one we've guided between 25% and 27% for the full year.

If you please turn the page to #12, you can see that as of March 31, our total net debt level was kept stable at around EUR 1.5 billion if you compare it to the year-end 2017. And the high free operating cash flow compensated the cash outflow of EUR 257 million for the share buyback program. If you look at the net financial debt level, this number even improved further in Q1 2018 from EUR 283 million end of last year to EUR 187 million at the end of Q1. And if you look at the ratio of total net debt, so again, including pensions relative to EBITDA, that number remains unchanged at 0.4x.



## APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

I would also like to remind you on this page that the first of 3 EUR 500 million tranches of our bond, which we had originally placed in March 2016 was duly repaid on March 10 of this year with existing cash. And the increase in pension provisions that you've noted is due to lower interest rates in Germany. So that a last comment on this page, our equity ratio further improved to 50%.

And with that, I would like to hand it back to Markus.

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

Thanks, Thomas. Talking on Page 13 on the confirmation of our 2018 guidance. Our first quarter results confirm that we are well on track for the year. Based on this, we fully confirm and reiterate our full year guidance on all our key performance indicators.

The core volume growth posted in the first quarter was fully in line with our expectations. Thus, we are confident of continuing to guide a low- to mid-single-digit percentage increase year-on-year for the full year 2018. This implies an acceleration in the coming quarters also helped by more favorable comparison basis.

We continue to assume a free operating cash flow for the full year 2018 significantly above the average of the last 3 years. We also expect the return on capital employed approaching previous year's levels. In the second quarter 2018, we expect our EBITDA to increase compared to second quarter 2017. We assume that we can achieve a positive pricing delta of more than EUR 200 million.

We foresee volume growth to contribute a high double-digit euro million amount. Please consider the reversal of EUR 74 million positive one-time items recorded last year. We again expect a similar burden as in first quarter 2018 from negative currency development.

Finally, we forecast a negative high double-digit million euro impact from higher operational cost.

For the full year 2018, we continue to assume that EBITDA will be around previous year's level.

Let me now close our session with a summary, which you will find on Page #14.

Global GDP growth remains favorable. We plan to grow in line with our industries. As detailed earlier, this growth path is supported by our smart CapEx approach short-term and with new worldscale investments long-term. This growth is expected to translate into EUR 5 billion cumulative free operating cash flow between 2017 and 2019.

We continue to return significant cash to shareholders. After the approval of the Annual General Meeting 2 weeks ago, we paid out an attractive dividend of EUR 2.20 per share or EUR 436 million in total. We also plan to, again, buy back shares with the start of the second sub-tranche imminent.

On 28th of June, we will host our Capital Markets Day in London. At this event, the management team and I will be pleased to present and discuss the strategy and outlook for Covestro Group as well as for our 3 segments. In case you have not seen the invitation yet, please be aware that registration is now open. I would be delighted to see you on this event.

As you might have seen in our Investor Relations news sent on April 13, Patrick will pass over his CEO duties to me on June 1. I would like to take this occasion today to thank Patrick personally and in the name of all Covestro employees for his outstanding contribution. He not only shaped the operational setup of the business well before our independence, but set the foundations in all aspects for a successful Covestro today. Also thanks to his mentoring in the last years, we are confident of following this path into the future.

Thanks for listening, and we are now open for your questions.

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APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) And I see that we have our first question here from Patrick Lambert calling from Raymond James.

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

Patrick Lambert, Raymond James. There are 3 questions, please, if I may. The first one, a bit of an outlook on the volumes short-term in Q2. If you could confirm the trends that you're seeing in the start of Q2 regionally and also by division? To get a little bit of a sense of how the acceleration needed is happening. That's the first question. The second question is a bit also on the new capacities. If you could tell us a bit what has started? What has been delayed? with Sadara, BASF, Huntsman? And how you see that pending out in the later part of the year? And finally, the EUR 390 million pricing delta in the Q1 EBITDA bridge, if I understand correctly about EUR 200 million come from TDI. Would the rest be mostly polycarbonates or split between MDI and polycarbonates?

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

Patrick, first and foremost, thanks for your question. It's Markus speaking. Let me just start with the volume perspective to give you some ideas. Let me start maybe with our overall volume development that we have seen for the first quarter. If you look into the volume development that we've had last year, and I think that is very important to understand the overall situation. In the first quarter last year, we had volume growth of almost 9% compared to the first quarter 2016. And we have pointed out in our presentation the major effects that we have seen. So in that regard, we started from a very strong basis that is now compared to the first quarter 2018. If we now go into the second quarter 2017, our volume growth was comparably low, exactly because we had those prebuying effect in the first quarter and some other influencing effects. That means compared to this lower basis last year, we are now assuming that we are back on track also in the second quarter for 2018 to deliver on the low- to mid-single-digit growth rate for the full year. So you would expect that we will be within this range in the second quarter, maybe even slightly above this range in terms of the volume growth for the respective businesses. We definitely assume that we will continue in PUR, in particular, to show some higher volume growth than we have seen in the first quarter, so we will turn positive here. We also would see that for the Coatings, Adhesives and Specialties. And we would also see that polycarbonates would contribute, again, like in the first quarter to this overall volume growth. In terms of regions, the numbers that we would see from that perspective, I think that Asia-Pacific would, again, contribute significantly to the volume growth because this is still continuing to be the growth engine and that we would see slightly lower growth overall for the group for Europe as well as North America. That would be my answer to your first question.

### Thomas Toepfer - Covestro AG - Chief Financial Officer & Member of Management Board

Maybe if I jump in for question number three. If I understood correctly, you asked, can we give some more color and detail on the EUR 390 million pricing delta? And how is that split by the segments? I would say 2/3 of that is attributable to the Polyurethanes segment and the rest - so the remaining roughly EUR 100 million - is attributable to the Polycarbonates segment.

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

Then doing last your second question, let's talk a little bit about MDI in that context. We see the SLIC expansion of 240,000 tons on an annualized basis has happened in January 2018. We see also that we have a continued Sadara ramp up. And we expect that this will lead to 225,000 tons assumingly. We also see that we have the Chongqing plant of BASF now working at higher rates. There are some assumptions in the market that they maybe use about 2/3 of their installed nameplate capacity. And that means that overall the industry utilization would decline to mid-80s to high-80s of capacity utilization, so roughly around 87% just to give you some idea. Despite those capacity additions and also coming back to what I said earlier on our supply, our supply was not restricted by lower demand of the entire industry and entire market. It was just restricted internally in terms of supply. And from that perspective, we saw, already last year, quite healthy demand that was above the average demand that we have put into our models. So the demand in the market was at 5% to 6%. And we see that the first quarter was in line with this demand again. That



APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

means we've very healthy growth rates and that's why also despite the additional capacity in MDI that we see, our first assumption is that the market is really quickly absorbing those additional capacities. Let me turn the page and talk a little bit about the TDI industry. In the TDI industry, the the Sadara ramp up is about to continue. We assume now 75,000 tons out of the 200,000 tons nameplate capacity. And we also see additional, maybe 120,000 tons for the full year from an ongoing ramp-up of the new German plant upstream the Rhine River in Ludwigshafen. And maybe also some few minor additions, some debottlenecking here and there also on our side. That means if we now look at global industry utilization, that is purely mathematically calculated, it is expected to decline and that will also lead to the normalization of margins in TDI as we already have stated numerous times in the past. And as we can now also observe in April already. So from that perspective, we think that in TDI, we will go to the mid-80s of industry utilization and that depends really very heavily on the actual demand in the months, but also on the actual startups, timing and also reliability of the plants. And as you very well know, the reliability of TDI remains to be seen. Let's put it very cautiously. Last but not least, please let me give you an outlook on polycarbonates. In 2018, in the first phase for Wanhua, 70,000 tons the first line or Line #1 started up in January. There are additional supply options that depend for sure on, as always, ramp ups. Our assumption is for the full year that there will be a ramp up, up to 130,000 tons of a new player called Luxi. This is two times 65,000 tons expected to start within 2018. Another 100,000 tons may be of Heng Yuan Chemicals in early 2018. They use a new technology, reliability is for us totally unknown. Then we have another player with 100,000 tons, which is Lotte, expected only end of the year, or eventually not happening within this year. And also one second phase is expected only in early 2019. That means global utilization, despite these capacity additions is expected to remain on a high levels. Also due to the fact that polycarbonates still is in very, very high demand. So from that perspective, we need this capacity in the market to continue to fuel growth for the entire industry. I hope that answers your 3 questions.

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

Just really quick, for Covestro and polycarbonates, how much kilotons can we expect from the debottlenecking in China?

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

We have said that the overall debottlenecking would include 200,000 tons and those 200,000 tons would come on stream starting of 2019. Within this year, you might see additional capacity of 50,000 tons. And those 50,000 tons on top of what we anyhow can do with other measures would actually also help us to get to this overall growth rate for polycarbonate, which is in line for Covestro, again, at low- to mid-single-digit growth rates. So everything is well on track in this context. And we will serve the market as the market needs it.

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**Operator**

And the next question comes from Laurence Alexander.

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

Laurence Alexander with Jefferies. Just wanted to dig in a little bit in the demand trends that you're seeing for MDI? Any markets that are coming in stronger than you expected? And is your baseline, the 5% to 6% that you saw in Q1, adjusted for the impacts of the Chinese New Year? Or does that imply that underlying demand is actually stronger?

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

So thanks for the questions, Laurence. As I said, MDI industry from our perspective is expected to grow between 4% to 5% on the short- to mid-term basis. That means in the next 3 to 5 years, and that is what we base all our models on. We have, however, seen that last year the growth rate was more 5% to 6%. And that's also what we assume was the growth rate in the market for the first quarter. And this growth rate has also included the Chinese New Year, and that also has included, from our perspective, the quite lower demand in the construction industry due to quite adverse weather conditions that we have seen, so harsh winter. It would be a bit speculative from my perspective now to expect that despite these special effects in the season, we would see then an additional top-up in demand for the second quarter or for the remainder of the year. I think we would



APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

be well off if we would just consider that we have had a good start into the year, that MDI demand, overall, is very healthy. And that also for the full year, we still base our assumption on the 4% to 5% growth rate overall. And that is also then reflected in our overall utilization models and industry utilization. Does that help?

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**Operator**

The next question comes from Mr. Faitz.

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

Christian Faitz here. A couple of questions, if I may. Also on the demand side/volume side. You mentioned the adverse conditions affecting the MDI market in construction demand quite a few times, Markus. Is Chinese construction back from what you've seen in your accounts? And then also can you talk a bit about PCS trends in automotive? What you currently see in terms of current demand trends and in polyurethanes? And then maybe also elucidate a bit on demand in general in PU and isocyanates and polycarbonates in the U.S.?

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

Yes, with regard to your first question, MDI, if I picked it up, Christian, then I would say the MDI demand is not directly related to the overall construction industry. What we see is that the demand of insulation of buildings is still growing above, let's say, the general construction market. And despite all conversations that we have in all of the announcements that you see in some states or in some countries, this demand is still very healthy. And that is exactly where polyurethane, and particular the MDI, is used to the majority of the extent in this insulation purpose. So from that perspective, we see that also MDI demand going forward into the year will continue to be exactly in this line for 4% to 5% for the insulation of commercial and private buildings. I do not see that we really have an issue here and going forward into the year. If we now look into polycarbonates, automotive and transportation was quite healthy. In particular, if you consider that the overall passenger vehicle market, year-over-year, in the first quarter was more or less at around a sluggish 1%, whereas the automotive and transportation segment that we served was up 4% year-on-year. That really shows that we continued to position more polycarbonates and also that we will continue to replace other materials in automotive interior as well as exterior applications. So from that perspective, I really see that polycarbonate, despite what is going on in primary underlying demand in the car manufacturing industry is and, from our perspective, will also continue to be in high demand. That also means, coming back to the polyurethanes industry in general, as I stated a little bit earlier, we see that across all industries and applications we are serving, we have some seasonal fluctuations. That is true and that is what we will also continue to see. Yet, we do not see any major impact on the overall mid- to long-term growth rate between 4% and 5% for the polyurethanes industry. And that goes really across the board. And also, here we see in different applications, be it the monomeric MDI, for example, for applications of so-called artificial leather. But we also see this for the polymeric MDI for other applications, still nice growth rates across the board and across all regions.

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**Operator**

Next up, we have Mr. Wrigglesworth.

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

I'm Tom Wrigglesworth. I am from Citi. A couple of questions, if I may. Thomas obviously spent a bit of time telling us to be cautious about the ICIS news. And I'm interested to understand better what developments on near-term you're seeing in pricing because what we think we're seeing is a bit of softness in TDI in Asia. Are you expecting that to start to impact the second quarter? And MDI prices seem to be a bit mixed between monomeric and polymeric as you mentioned earlier. So what's the aggregate MDI kind of development at the start of Q2? And the second question, if I may, is obviously, we are after Chinese New Year, the environmental taxes are in place in China. Have things changed at all from what you're seeing on the ground in China with regards to environmental constraints? So are we in a similar situation as we were at the end of last year?



APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

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

Thanks, Tom for your questions. Let me start with MDI. As you pointed out, MDI is monomeric as well as polymeric. And if you look at the ICIS charts, and I will continue to sing the same song sheet that Patrick did, they're only partially reflecting what is really going on in the market. So I tried to share a little bit more how we look at it. MDI prices have started to normalize a little bit within March. But they also have started already to recover or I would say stabilize from mid-March onwards. So we see on the MDI price front, in particular, in Asia-Pacific that prices have stabilized. And therefore, this is exactly what we have expected that MDI is structurally in a well-balanced situation. And we do not see that this situation will mid-to long-term really change because as I said, capacity additions and the demand are pretty much in line. So from that perspective, the short-term peaks that we've seen, for example, starting in fourth quarter last year are now coming to an end. But the prices now have, from our perspective, stabilized. And they have actually not so much moved for monomeric MDI, they have rather been more volatile for polymeric MDI. And the third aspect that I would like to bring in due to the product mix, our prices have neither gone significantly up in fourth quarter in that sense. But they also have not now gone the same way down as you might see it from official charts. So overall, our prices were much more stable than the official charts actually are showing it. So that is on the MDI prices. On TDI prices, yes, we see that prices have come down in Asia-Pacific and that they most likely also will continue to come down. So from that perspective and we have outlined that already, we see that we have had continued fly-up margins in the first quarter. Thomas has also lined out what that means in financial terms on a full year EBITDA, and how much the EBITDA contribution in terms of the bridge was year-on-year. But overall, all these developments we are currently seeing are not unexpected, but rather have been reflected already in what we have either stated about the quarters that are behind us or they have already been reflected in the full year guidance for 2018. Did I capture everything?

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

Sorry, the environmental...

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

The environmental topic. Actually, we have not seen, let's say, any further impact. If you look at the ban of scrap plastics to be imported into China, that has lifted up our sales. And as I said, polycarbonate is not only globally, but in particular in China, in very high demand. And we see very good growth opportunities also in polycarbonate. So from that perspective, we do not see any further impact on that.

**Thomas Toepfer** - Covestro AG - Chief Financial Officer & Member of Management Board

Just to clarify that, the polyurethane industry and also the polycarbonate industry are actually almost not affected at all by any kind of forced closure. So you might have seen this with some kind of old chemical plants, so to say, but we have not seen it specifically in our industry. So there were no forced closures, there were no forced relocations. And therefore, the industry effect was so far limited from the new environmental regulations.

**Operator**

And the next question comes from Mr. Swoboda.

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

This is another Thomas on the call, Thomas Swoboda from Societe Generale. I have 2 questions, please. First, on polycarbonates. It feels like that since Q4, we have a nonrecurring component to the earnings. Please correct me if I am wrong. If so, could you help us to split that out? How much of the improvement should you be able to keep through the cycle considering new capacities and so on? So that was the first one. The second one on TDI. A little bit more complicated, I'm sorry for that. If I understand your numbers correctly, the wins for profit from TDI was still increasing



## APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

quarter-on-quarter in Q1. So in terms of the normalization of pricing, looking into Q2, do you see the additional windfall profits, you have had in Q1 on top of Q4 going away? Or should we expect a stronger deterioration in TDI earnings?

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

Okay, I would like to start with the second question on TDI because that is the more complicated. But I hope I have a more easy answer to that. And to predict what is going on in TDI is extremely difficult to be very frank. And you might have seen that because we're talking now since 8 quarters of fly-ups, it was maybe not a fly-up anymore, but it was meanwhile a plateau that we have gone through over the last 8 quarters or 6.5 to 8 quarters. And we definitely see that prices started to normalize exactly as we have predicted. And if you now look at the full year effect, we still believe that for full year 2018, we will see, compared to the full year 2017 effect, something around minus EUR 250 million. We are not, frankly speaking, in a position to really say, will that all happen and to which extent, exactly in which week or which month because as earlier outlined, the current ramp ups that we are seeing seem to run kind of okay-ish. We see material in the markets, we see that customers have larger or greater opportunities to choose from different suppliers. But we also have to always reiterate about the reliability issues and also the ramp up issues that we have seen and that we continue to see in the entire industry. So from that perspective, for the full year, we still believe that we will see EUR 250 million being deducted compared to 2017. And maybe then for the next year, another EUR 250 million, so that prices will have fully normalized. For the first question you've asked, I would now like to hand over to Thomas.

**Thomas Toepfer** - Covestro AG - Chief Financial Officer & Member of Management Board

Thomas, it's Thomas. To your first question, in terms of polycarbonates: I maybe wouldn't call it non-recurring component, but maybe to shed some light on the uplift that you're referring to. So you see that we had an EBITDA number of EUR 303 million in Q1 2018, and that's an uplift of roughly EUR 70 million relative to the quarter a year ago. And speaking rough numbers, I think one could say that maybe 50% of that is attributable to specifically the scrap ban that we've seen in China. Whether or not this is long-term sustainable is a different question, but I think it's the special effect that we can definitely point your attention to that plays into this development.

**Operator**

The next question comes from Mr. Haire.

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

This is Geoff Haire from UBS. A lot of my questions have been answered. Just wanted to ask a question on the range of EBITDA spreads for polyurethane. So I think a year ago, you'd indicated that the sort of trough to peak spreads were somewhere in the region of 22% to 8% and that was based on oil price probably sort of close to \$100 a barrel. If you could update us what your thoughts on that at the moment, given what you see in the market? And then secondly, I was just wondering, could you update us on your thoughts of capital allocation, particularly, on M&A? What are your thoughts on that, please?

**Thomas Toepfer** - Covestro AG - Chief Financial Officer & Member of Management Board

Well, maybe let me start with the second question, talking about capital allocation. I think the overarching theme when we think about capital allocation is shareholder value. So everything that we look at and do is really governed by the thought, how can we create best shareholder value? And you've seen that we have embarked on a number of different activities. First is, we have dialed up our capital expenditure for this year, where we've guided EUR 600 million to EUR 650 million, a significant uplift on 2017, simply because we think the allocation towards expanding our production capacity is extremely useful to cope with the demand and strengthen our position as the leading player with the leading cost position in the industry. So this is definitely one direction. The second one, you've seen we announced our share buyback program in October last year. And we have executed successfully the first tranche of it. So we will embark on the next tranche shortly. And then you're specifically alluding to M&A, I think it's fair to say, yes, we're looking left and right. But again, let me reiterate, creating value for the shareholders is the topic that we have in



APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

mind when we look at this. I think this is a little bit the magic triangle in which we move. And we can assure you that we will be well-balanced and very rational on whatever we do.

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

Geoff, this is Markus speaking. On your first question, we have seen historically quite a large spread in terms of PUR margins. If we now look into the more recent past, for example, looking into the full year 2017, excluding the fly-ups that we have seen for TDI, we would have been around 20% for the entire polyurethane business in our portfolio in terms of EBITDA margin. And that is a margin level that we deem to be very appropriate to reflect 2017. And that we also might see in an overall context not to be totally unrealistic. The margin levels that you mentioned, for example, the 8%, if I just captured it correctly, that we were seeing in this industry, were on very special conditions. And those very special conditions are: we were coming out of an economic crisis, where actually demand was totally going away and was reset on a very low level. In addition, we had a large amount of additional capacity coming at the same time. So we suffered for almost 6 years of very low demand or a demand that started from a totally low jump-off point. And at the same time, massive capacity additions that the industry has never seen before came in. And we simply needed to grow out of this. If we look at what we have communicated and now we look at the overall supply and industry demand balance, you see that for the next couple of years, 3 to 5 years, we see that the industry will be very well-balanced. And that also should give you an idea, given the industry utilization, given the capacity additions, given the very healthy demand pattern that those margin levels that we're currently seeing are not unrealistic also to be assumed for the near- to mid-future.

**Operator**

And the next question comes from Mr. Heine.

**Andreas Heine** - MainFirst Bank AG, Research Division - MD

Andreas Heine from MainFirst. A couple of small questions left. Maybe more housekeeping stuff. In polycarbonate, the maintenance you have in the second quarter, is that something we have to have in mind if it comes to forecasting the earnings of that quarter? Or is that basically running through with inventories already in place? Secondly, on the delta you mentioned of more than EUR 200 million in pricing for the second quarter. Do you think that all of the 3 main products would contribute to this TDI, MDI and polycarbonates? Or is that then focused on MDI and polycarbonates only? Lastly, on the share buyback program, could you remind me what you mean with these tranches? So you bought back EUR 250 million in the first quarter roughly? How do you expect this to go on now as you are in the decks and probably have higher liquidity in the stock so you could buy up more? Is that something where you would like to speed up, given the depressed price we see right now?

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

That may be a bit unusual, Andreas. But I start with the last question, and Thomas will then go for the first and the second question. Talking about the share buyback program. If we talk about tranches, what we mean is we've actually finalized the first tranche, that means we have bought back about 2% of the shares with an overall amount of roughly EUR 400 million. And we have stopped this before the Annual General Meeting also to avoid, let's say, any potential problems with, for example, the proxy advisors. And we will, in very due course, resume buying shares back with the second tranche, and we'll execute it very swiftly. Under the German legislation, we are quite limited in terms about how much we can actually buy back each and every day on the stock market. So we are limited to about 25% of the daily traded volumes in terms of buyback. That means even though we would love to accelerate, we can't accelerate because that pretty much depends on how much is traded on a daily basis. So given the current rates at which we have bought back, and we assume that we can buyback, we still would need to stick to the original communicated date of roughly mid-2019 before we can finish actually the current program, which would be either up to EUR 1.5 billion or up to 10% because. Those are the 2 natural limits that set the limit to finish the program. So we are doing it at a maximum speed possible, but still given the overall circumstances, we still assume that it will take about another 12 to 14 months before we close the program.



APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

**Thomas Toepfer** - Covestro AG - Chief Financial Officer & Member of Management Board

And then with respect to your other questions, I think the one question you asked is, how can we split our guidance of more than EUR 200 million pricing delta which we expect for Q2. I think I would come back to what I said earlier when we talked about the pricing delta in Q1, and I said 2/3 of that can be attributed to the Polyurethanes segment. And I would say roughly speaking, the same 2/3 could be attributed for Q2 as order of magnitude and then the rest of that goes to the Polycarbonates segment. I think that is the number that I would work from. And then to your other question, the maintenance shutdown. First of all, we built up some inventory in order to be able to cope with that from a volume perspective. So you should not see that. It will, however, have a low double-digit effect in terms of our EBITDA. So nothing which is so meaningful as we would kind of slip it out as a separate item in our bridge, but this is the order of magnitude we're speaking about.

**Operator**

The next question comes from Chetan Udeshi.

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

It's Chetan Udeshi from JPMorgan. First, just a quick clarification. Did you say on the call earlier that you are actually seeing a stabilization in MDI prices in Asia and China at the moment?

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

Correct.

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

Okay. And second question, can you just give us -- I know you've talked about second quarter net pricing benefit of more than EUR 200 million. So what do you include at the lower end of that range in terms of say, EUR 200 million versus a number which is probably higher than EUR 200 million? That's number two question. Number three, on TDI fly-up, is that a reason for you to think that TDI fly-up is as high as you've estimated since the beginning of 2017 because clearly we've seen Sadara sort of ramping up through end of last year, early this year? But yet we've not seen the same kind of impact on TDI prices at least till now.

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

Okay. Chetan, on the last question that you have asked. It is, as I said, and I just have to reiterate it on a quarterly, monthly or even weekly basis to really judge on how the new capacity will really impact the pricing situation, and also the margin situation is extremely difficult simply due to the fact that we just rely heavily on public announcements, we rely heavily also on second, sometimes first-hand information from consumers, but not, let's say, on a statistically relevant basis. So all we can say is that we hear, as I said earlier, the capacities that I mentioned seem to be running. Some of them seem to be running at least at reasonable rates. We've not yet heard that any of these capacities have not ramped up successfully. So given that, we might not expect that all capacities run at 100%. And that's why the fly-ups that we've seen, from my perspective are not overstated, I think it's just now a matter of time until we will see the full effect. And that's why we also continue with our guidance for the full year 2018 of roughly EUR 250 million. And I think we will see those effects coming in in the second quarter already. That's the current best guess that we have. If you recall, we said, we assume just for mathematical reasons that the majority of the effects will come in the second half. Now the TDI prices have already started to normalize a little bit, and that's why we think that we will see first effects already coming in in the second quarter. But for the full year, our overall guidance on what the fly-up effects will be for 2018 remains unchanged.



APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

**Thomas Toepfer** - Covestro AG - Chief Financial Officer & Member of Management Board

And then maybe just on your last question, when we speak about pricing delta, I mean, we refer to the delta between the effect from selling price and the raw material price, so I mean you have a little bit of uncertainty on both sides. I think it's no secret that we expect selling prices to normalize over the course of the year. And yet, we do think that the delta between those 2 numbers should be positive, north of EUR 200 million. And I somewhat regret that I don't think we can be more precise than that. I think the bridge we've given is kind of the degree of precision that we feel comfortable with to communicate to the market.

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

So the other way to ask that question is you are assuming that there is a further price moderation through the quarter in that EUR 200 million net impact already?

**Thomas Toepfer** - Covestro AG - Chief Financial Officer & Member of Management Board

That is the fair statement, yes.

**Operator**

And our last question for today comes from Mr. Walsh.

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

There's pretty much nothing left to ask other than the fact or rather something about CAS, please. Just help us understanding what your outlook is for that business, recovery of raw material cost inflation? Maybe any dynamics going on in that business that we should be aware of?

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

Paul, this is Markus speaking. I think most important is that CAS, from our assumption, will be back to the growth path for the full year 2018. And we expect that the entire business will also contribute, not in terms of volumes because it is a rather small volume business compared to the 2 larger business units. But in terms of percentage of growth, it will definitely also contribute to the low- to mid-single-digit growth. And that's why, we're looking on the CAS segment to be very frank, quite positively because we really see that we have bottomed out in terms of the growth opportunities and it still remains to be a high margin business and a very resilient margin business because the margins that we've seen, again, in first quarter of 2018, despite the slightly diluting effect of the elastomers business transfer, and we said it is about 1 percentage point. By adding the respective additional businesses and shifting elastomers business, it is still, despite this effect, at 23%. And as we've always communicated, we deem that 22%-plus is exactly the margin level that we deem to be very healthy and also very stable to be continued in the future for Coatings, Adhesives and Specialties.

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

Is that something, Markus, we should bake in for 2018, sort of margin 22%, 23%, do you feel comfortable with that?

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

Well, I do not see, let's say, any signs that will lead me to the assumption that we would fall significant below 23% as of today. And so from that perspective, without giving, let's say, any clear and specific guidance on the coatings business, I can say that it is a very stable margin business, has also been proven to be a quite stable margin business. All the effects where we've seen, for example, in fourth quarter 2017, a negative margin



## APRIL 26, 2018 / 1:00PM, 1COV.DE - Q1 2018 Covestro AG Earnings Call

effect were predominantly due to the volume effects. And overall, I have to say that with now the volumes getting more and more back on track, I would believe that we can easily achieve something around 21.5 to 22-ish percentage points even on a more conservative side.

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**Operator**

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

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**Ronald Koehler - Covestro AG - Head of IR**

Thank you for all listening. And we will see us latest at our Capital Markets Day in June. And if you have more questions, just come back to the IR team. Thanks and bye.

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**Operator**

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

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