Analyst Conference Call Q3 2018
Transcript Q&A
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Andreas Heine (MainFirst): One question on the outlook: At least in my forecast, given the high base of Q4 2017, I am at the low end of the guidance range you have given. How comfortable are you with your guidance? What should not happen that you stay within your guidance in Q4?

Dr. Martin Brudermüller: If you look at the mathematics of EBIT before special items, then we are year-to-date basically 6.5 percent below the level of Q1 to Q3 2017. If you look at the businesses, I think, Hans alluded to the expectations for Agricultural Solutions. We said this also last time: If you see the price development and everything, we still expect that there will be a gradual improvement in the Performance Products and in the Functional Materials & Solutions segments, that they could accelerate in the fourth quarter. That will be certainly offset by a decline in the Chemicals segment because we have also to compare here against a very, very strong Q4 2017, driven by the isocyanates.

If we expect – and that's what we expect – that Q4 will certainly be lower than last year's Q4, but still reasonable, then we are still in our budget guidance. That is actually what we also confirmed today. That is our expectation: Q4 will be weaker than in 2017, but it is still for the whole year in the guidance. That's why we do not correct anything; that is what we currently can see.

Hans alluded to the situation of the auto industry. In the outlook, we have only taken reference to the auto industry in particular. We did not talk about other industries because we cannot see, at the moment, a significant downturn in the other industries. It is really very much on automotive at the moment.

With all these effects which I just talked about, we still think from today's point of view that we are in the guidance.

Chetan Udeshi (JP Morgan): Just looking for full year now and Q4, you still say "slight" which is a 1 to 10 percent decline. Do you have any specific number that we should be keeping in mind for full year now, given that the past three quarters are already reported?

When you look at the historic seasonality in your business, Q4 is down quite significantly versus Q3. Is there a reason why this time Q4 is going to be different from the usual seasonality?

Dr. Martin Brudermüller: There is no more information on that one than what I gave already on the question of Andreas. You know also the wording of "slight" and "significant". You see the wording we have. We keep the guidance. This is why we think the mathematics goes in this direction.

Thomas Wrigglesworth (Citi): The question is with regard to the developments that you are seeing into the beginning of the fourth quarter: Could you describe a little bit specifically with regard to the automotive and your industrial chemicals exposure whether you are seeing a change in order patterns or whether you are just seeing a destocking and that's accelerating or you are seeing there is something more structural to demand?

Dr. Martin Brudermüller: Thomas, a little bit more on automotive: We have seen, particularly in September with basically 9 percent down, a significant production reduction in automotive. I think there are no stocking or destocking effects in that very short period of time. I think it directly translates into consumption of major chemicals. As you know, we supply a relatively broad portfolio to cars. So, we paint the cars, but we have also a lot of plastic materials in the car. And we certainly have also fluids and we have also the catalysts in there.

With this, it's impacting quite a part of the business. You also know that automotive is our most important customer industry, with more than 18 percent of sales. With that, we see also basically an immediate impact here.

But let me also mention – this is why we have written it like this: It is very much the automotive industry that is affecting us here, whereas the other markets are still in good shape.

Gunther Zechmann (Bernstein): On the macro outlook. The chemical production that you have updated: You don't expect any longer that this will outgrow the industrial production and GDP. Can you just take us through what the key drivers are for the reduced macro guidance?

You have also been quoted on Bloomberg this morning, saying that you hope automotive will pick up in the coming months. Is that a gentle optimism or have you seen some tangible finds that you have troughed in that end market?

Dr. Hans-Ulrich Engel: To be honest with you: September was a little bit of a surprise to us, the developments that we saw there. We had gone into the month of September after July and August, considering the seasonal effects, looking very normal. And then we saw this dip in demand in the month of September.

You are very familiar with the developments, in particular in the western European automotive markets: new emission standards, the producers can't test their cars quickly enough. That has certainly led to a number of issues. But we have also seen a certain slowdown in Asia and there most pronounced in China.

What's going to happen there in Q4 remains to be seen. Overall, we came to the conclusion to reduce our figures for industrial production and for chemical production, I want to say, slightly. This is an adjustment that we made there, yes, but don't overinterpret that, please. It remains to be seen how things will actually develop in Q4. Martin already alluded to the tax stimulus in China [see page 6 of this transcript], which may very well play a role. In the western European auto markets, let's see, whether there is pent-up demand that will be satisfied then during Q4.

So, a number of things that can impact Q4 remain to be seen. But I think it's fair to say, we don't see any type of structural issues. We saw a dip in demand in September and we take it from here.

Gunther Zechmann (Bernstein): Just to follow up on the comment that the auto slowdown will pass in the coming months: Is this something you have actually seen in your order books?

Dr. Hans-Ulrich Engel: I want to say, that is too early to say. When I look at our order books, that looks solid, that looks okay. But volumes were then slightly lower. You have seen in our cash flow the dip that we had there. At the end of Q3, as a result of this dip in demand in particular in auto in September, we sat there with inventories which were too high. But the order books look okay.

Thomas Wrigglesworth (Citi): You mentioned fixed costs a lot, specifically with regard to FMS a surprise, given that there was volume growth, but you were also saying fixed costs increased. Could you just elaborate by division what was driving the fixed costs? I think we can understand the components in Chemicals quite clearly, but in the other divisions it’s not quite clear to me what the fixed cost driver is there.

Dr. Hans-Ulrich Engel: Your question with respect to fixed cost development in the BASF Group and the drivers for fixed cost increases: The biggest driver for the fixed cost increase that we have is the Bayer acquisition that we made. If you recall: We closed that in August. That’s driving up fixed cost significantly, at a point in time where there were hardly any sales of the new Bayer products in our portfolio in Q3.

In the other segments, you have a mix of new activities or new plants that came on stream, such as e.g. new catalyst plants or new catalyst lines in Functional Materials & Solutions. We also increased coating capacities. That brings a certain full-year effect. That’s also in Functional Materials & Solutions. We had some smaller turnarounds in the Performance Products segment. All of that combined, leads to an increase in fixed cost.

What’s also reflected in the fixed cost, at least to a certain extent, are the costs that come with the low water levels of the river Rhine. That’s something that we are coping with since, I would say, the mid of June. That has increased cost also by way of underutilization cost because we had to throttle back some of our plants due to the raw material supply situation.

Thomas Wrigglesworth (Citi): Sorry, just as a follow-up, Hans: Could you help quantify, dimensionalize the size of those one-time items in the fixed costs in the third quarter?

Dr. Hans-Ulrich Engel: The one-times that we have, if I think about the cost resulting from the low water levels affecting activities and operations in Ludwigshafen plus turnarounds, are in the area of a higher double-digit million-euro figure.

Sebastian Bray (Berenberg): There seems to be across the value chain in chemicals a tendency towards higher raw material cost. I am thinking in particular of power and carbon pricing, particularly in Europe. Does BASF think of higher carbon prices – they have more than doubled this year – in 2018 and 2019 as a particular headwind? Any idea of quantification, as far as you can give it, would be helpful.

Dr. Hans-Ulrich Engel: We certainly experienced higher raw material prices, obviously not only driven by carbon prices. You refer to power, an interesting situation there. Not only the river level of the Rhine is low, but there was also less power generated by renewables than what was expected. That led to high power prices in Q3.

Overall, we have a material cost increase in Q3 which is predominantly driven by the oil price. Keep in mind: Roughly two thirds of our raw materials are hydrocarbon-based. We have seen an increase in raw materials in Q3 in the order of magnitude of 13 to 14 percent, that we had to cope with. Power was more expensive. At least in Germany, we produce a lot of the power ourselves, but the gas prices have also increased significantly. So that plays a role there.

The CO_2 certificates have moved up in price from 8 euros to, I think, slightly below 20 yesterday. That's also a cost driver. But please understand that I will not give you a specific figure on CO_2 certificates and what kind of cost that means for competitive reasons.

Christian Faitz (Kepler Cheuvreux): Coming back to the low water levels: In terms of costs pertaining to those water levels, looking at Q4 and the even more severe situation at least at present versus Q3: Can you comment on the cost increases and your ability to produce for Q4? My understanding is that your cracker is currently running at 60 percent or so. Is that correct?

Dr. Martin Brudermüller: Some more information on the water level: First of all, it's a very, very unusually long period that we are bothered with this. We had this in the past happening for one or two weeks, but this is now a situation that basically since summer is accompanying us.

This is very much on two issues: One was in the summer time very much on the cooling water because you have a kind of temperature restriction to bring the water back to the river and now, which is becoming even more fierce, it is really the transportation issue. So, basically, shipping is almost not possible anymore, even if you reduce the load. That is the first measure you take: You go from 100 percent to 50 percent to 25 percent load, but now the water level is so low that basically shipping stopped.

We have worked significantly to bring more cargos to road and rail, but that has its limits because with 2,500 ships over the year, you simply cannot bring all the volumes to rail and to road.

With this, we have now more a material issue and a supply issue than a cooling water issue. With this, the impact, over the next months, will get slightly more severe, I would say. You can imagine that we hope for rain because that would ease the situation very quickly.

What we actually have done now is that we have indeed reduced the level of utilization in the cracker; we took it down to about 60 percent. That is more or less what we can cope with, bringing the raw materials in by rail and road. This is, I think, a more stable situation going forward, but this certainly means also that the consuming plants down in the value chains suffer.

The other issue which is really driving up costs now is, on the one hand, underutilization, and on the other hand higher transportation costs by using rail and road versus the ship. It could ease easily from one week to the other if we get significant rain. But if not, we have to go on with roughly this utilization.

Patrick Lambert (Raymond James): Sorry to come back on the Rhine issue. In my calculation, the impact in Q3 would be like mid double-digit at EBIT level. How do you see Q4 in terms of maybe some early estimates of the impact of underutilization and the logistics issue, maybe a worst-case scenario there? If you could help us figure that out.

Dr. Martin Brudermüller: Patrick, as I mentioned earlier, taking down the utilization just happened now. I explained a little bit the different reasons. We had the cooling water effect, now more the transportation and the shortage in raw materials.

You can imagine: If that continues or if it theoretically would continue over the whole fourth quarter, the impact would be significantly higher. However, it is also relatively normal that in November, latest, it rains in Germany. So, we still think if we look at normal weather patterns – it has been unusual the last months –, if we think in that direction, it basically can come down and normalize relatively quickly, even within days.

I would say, if you want to have an assumption, if you take worst case, your mid-size double-digit million impact on the earnings is right for Q3. If it continues the whole Q4 like this, it is significantly higher. But on the other hand, the probability that it will rain and with that the situation will normalize, I would say, is higher than the first scenario.

Patrick Lambert (Raymond James): Just a follow-up: I saw some force majeures already on a few plants. Could that mitigate part of the impact in case it doesn't rain?

Dr. Martin Brudermüller: Well, I think, if it doesn't rain, we stay on allocation and the force majeure stays for some more time and then we have basically a lower business than we could have by the demand of our customers. That's the normal consequence out of it. But as I said, with one day of strong rain, two days of strong rain it normalizes quickly.

Patrick Lambert (Raymond James): So, we will look at the weather then.

Dr. Martin Brudermüller: Yes. And that's what we do every day.

Tony Jones (Redburn): On China: How are you seeing the opportunity for China in 2019 and maybe longer term, given some of the issues you call out? What does that mean, if anything, for BASF's long-term investment plans?

Dr. Martin Brudermüller: Your question about China long term: I think what you clearly see – this is what I also mentioned in the current situation and also a little bit in the outlook – is that China is certainly suffering from the trade frictions with the US. But I have lived long enough in China to know that the Chinese will not give up in that conflict. I would say, they are rather smart and creative in finding measures to somehow cope with this.

Certainly, they are bothered now about exports to the US. This is why you see a slowdown over there. But on the other hand, you might have heard also that the government has recently announced tax reductions. I have to say, having lived there for ten years in the past: That's typical China! They take a measure. This is a state system where there is one man at the top and he says: Now this is going to happen. They reduce taxes, and, with this, they will increase the consumption power. In China, that will happen very quickly. That doesn't take months to be established. Sometimes that goes over night. I think this is one measure to stimulate now in the coming months the consumption pattern.

For that reason, it could very well be that we see already an uptick with these measures in Q4. That's exactly the intention they have.

In that respect, yes, they are in a difficult situation. But, honestly spoken, I believe in pragmatic solutions. Somehow, I think, the US and China will find a solution that no one loses the face. I am also pretty optimistic that the Chinese have a policy mix in taking measures to somehow stabilize their economy. That's why I am not so much worried long term.

Tony Jones (Redburn): And the investment plans are unchanged as well?

Dr. Martin Brudermüller: Yes. Tony, you know: If we talk about a big cracker project in Guangdong, we really think long term. You have to figure out whether you do the right step for decades, actually, because planning and building this, you have maybe asset lifetimes of 40 or 50 years. If you have once a big site, you have it forever. We believe in the pattern, in the big consumption pattern in China. That is why we are not worried and will not change our strategy now that times are a little bit rougher.

You might know that this is in Guangdong, in Zhanjiang, which is a 7-million city in the south on the way to Hainan. If you look at the figures of Guangdong, this is the largest province in terms of inhabitants, 110 million people. They passed the GDP of Russia this year, strong double-digit growth. This is the industrial center and heart. By the way, they import 20 million tons of chemicals each year. I think the strategic set-up fits perfectly. We will not change this only because now a few quarters are maybe a little bit more difficult.

Laurent Favre (Exane BNP Paribas): The question is regarding the strategic review. Should we take today's announcement on construction chemicals as the reason of the overall strategic review in terms of portfolio or should we expect more, especially regarding Performance Products? I was a bit surprised that you talked about the challenges of running construction chemicals, given that this is exactly what "We create chemistry" was about. I guess, in Performance Products there have also been assets where you have had some challenges.

Dr. Martin Brudermüller: Laurent, this announcement about construction chemicals, I think, fits totally in the line what we have done so far. I think you know also our chart which is in the equity story, that we are pretty active in terms of acquiring and divesting. That's just one more thing we want to do. If you put it in line – water chemicals, then you saw leather and textile in the past, you see it with Wintershall, now comes construction chemicals – I think, it just shows that we continuously put all these portfolio parts on the block and review them continuously.

If there is an opportunity and if we come to the conclusion that a business could maybe do better outside of BASF and we do a value-enhancing step by following such an opportunity, then we will do it. I think it is a consistent work. You should also expect that going forward.

On the other hand, all the measures which we will take to reposition and position BASF better in the future, that is what Hans and I are going to tell you on November 20. So, I will not talk about these measures today. You expect that we have done, I think, a good portfolio job in the past and we continue step by step by looking into this. You should not see any policy change as of now, and just have a little bit of patience until November 20.

2 Segments

2.1 Chemicals

Paul Walsh (Morgan Stanley): On Chemicals, just thinking about the run-rate of profitability. I am curious to know if you think Q3 was a fair reflection of the reset in petrochemical margins and in polyurethanes. Maybe any other comments you have got on the other major product chains, whether it's acrylics or the nylon chain etc., how they are panning out from here.

Dr. Martin Brudermüller: On Chemicals: Let me start with, I think, really the major lever for change here: isocyanates. You know that we had a very special situation last year, a very nice one, I have to say. We expected that this cannot proceed forever like this; it somehow had to normalize.

I think we have been somehow lucky that the first two quarters were more or less strong and this very special period took longer than we thought. But we clearly saw in the third quarter that there is this normalization now. So TDI and MDI prices have come down significantly in almost all regions in the world. That is also related to additional capacity that came on stream.

We had in recent months rather, from a seasonal point of view, weaker months for the isocyanates. We also expect, however, that the next two, three months in comparison to other years should be stronger months. That is certainly the most important factor in Chemicals.

The other part that is impacting us is the cracker margin situation which is stressed, particularly in the US. There is an ethylene oversupply which, I think, will not go away for quite some time. These are the two major impacts which we see.

In other businesses in Chemicals, we have a rather nice stability. You mentioned acrylic acid, which is a strong leg of BASF, which has, I would say, a relatively sound demand, also the margin of our integrated production is on a good level. You know that we are very strong in this. I think it is expected to stay on a very healthy level.

In most of the other products, I think, there is nothing shifting significantly. So, we have these two effects now going forward. Overall, in the basic chemical products and on the raw material side, it's rather getting a little bit more constrained, whereas, I think, in this situation, the pricing for our products is in a kind of medium situation. That is how I would describe Chemicals at the moment.

Chetan Udeshi (JP Morgan): On monomers: You have talked about lower sales volumes in the isocyanates business. Why were your volumes lower, given that, I believe, you are now ramping up your new TDI plant in Germany?

Dr. Martin Brudermüller: On the sales volume of isocyanates: If you have a situation like this where the prices for TDI and MDI in all regions go down relatively steeply, you play in your policy between volume and margin. That is something every producer does differently. It depends also on your customer portfolio. For us, this is the situation and the best maximum-value optimization we do.

The second part: You already know that with the TDI plant here in Ludwigshafen we have also some restrictions with the Rhine at the moment. That is the best way to guide that business for us at the moment.

Tony Jones (Redburn): On cracker margins: Is there anything strategic you could do, perhaps with a third party or tactically by adjusting the feedstock mix to improve the regional cracker margins?

Dr. Martin Brudermüller: The cracker business: I think there is not so much we can do on a short-term basis here. First of all, let me mention that the Port Arthur cracker is relatively strongly flexiblized in terms of feedstock. That was a project we have established quite some time ago. So, we can actually flip from a kind of purely naphtha-based to a kind of mixed feed. That is also the same thing we address on the Antwerp site: to flexiblize. These are the two major assets here.

On the other hand, in Ludwigshafen, this is limited, I have to say, but that is also, with the supply situation, not so easy, also the tank farm situation. By the way, here, also in Ludwigshafen, we need the split we have because that is also the consumption pattern of the downstream businesses.

I think there is not so much to do. You know that, overall, we have a net-seller position in ethylene because we usually use the other products more intensively. Overall, we are tied into a grid. You know that from Ludwigshafen we have two pipelines going north and south; so, we can also manage there to stimulate this by the respective contracts and discussions with our partners or clients here. But I think there is not much more we can do. But we definitely benefit already day to day from the feed flexibilization.

2.2 Performance Products

[There were no specific questions on this segment.]

2.3 Functional Materials & Solutions

Andrew Stott (UBS): On the strategic decision to look for a partner or indeed sell Construction Chemicals. I am just wondering what it is you would look for in a partner. Or indeed, why would you separate the asset and when? I guess, it's not a question of scale. You are number one globally in admixtures, number four in construction systems. You have owned the asset for 12 years since the Degussa deal. You have got a long experience in the business before the Degussa deal. So, what it is that you feel isn't right with BASF fully owning the asset?

Dr. Martin Brudermüller: Andrew, on the strategic decision regarding Construction Chemicals: I think you are right. These are two businesses, the one is the business with admixtures. This is also a business that is differently driven than the other part which are the construction systems. The first one is very much a project-based business. That is also something that is innovation-driven. I think we have the leading admixture technology here. With this – you are right – we are the number one. I think this is totally fine and you can run the business.

On the other hand, the construction systems business is a relatively complex business. It has a very individual situation by countries. We have, e.g., a different regional or local footprint than our competitors. I think we have mentioned also in the past that our business is relatively strong in the Middle East area where there are currently, I would say, with the situation over there, lower construction activities. That's why we are burdened there.

The current situation, where also others are offering their businesses, offers consolidation opportunities, particularly in the construction systems business, I think it is a positive thought to bring businesses together. With this, on a country and a local basis on the one hand, but also on a sub-segment level in construction systems, which is a very complex business, with different segments, there are opportunities to have a better market positioning as well as a cost reduction potential on the local level.

You know that we have done some smaller acquisitions to strengthen ourselves on the country level, like the Thermotek acquisition in Mexico for example. But that's a relatively tough work to do that country by country. I think the opportunity is here to be part of such a consolidation to really position the business better.

You also know that by the style or the kind of business it has a rather low integration with other BASF businesses. It is more on smaller orders, it has a relatively high complexity. I think, with this, it could really gain momentum if we use this opportunity of consolidation in the market. That is why we have decided to really check the opportunities here.

Paul Walsh (Morgan Stanley): The Construction Chemicals margin, the 2.4 billion euros in sales that goes to that business: How should we think about the profitability of that business as you seem to look for alternatives for it?

Dr. Hans-Ulrich Engel: Overall, as we said, it's a good growing, a well-positioned business. As you know, we don't disclose results below the segment level. I think, Paul, we would like to stick to that.

Paul Walsh (Morgan Stanley): And above or below segment average or division average?

Dr. Hans-Ulrich Engel: Functional Materials & Solutions, as you know, is heavily affected by the pass-through cost that we have for precious metals. I think, I leave it at that.

Markus Mayer (Baader Bank): On Construction Chemicals again: Given your strong position at admixtures and your preference to combine your business with a strong partner, are there any anti-trust issues at admixtures with any other players or do you think it should play out well to combine this business with anyone else?

Dr. Hans-Ulrich Engel: Difficult to answer, Markus. We are at the very beginning of the process. If you look at the competitive environment: Could there be issues in certain combinations? Yes, there could be. In others there are none. Sorry, there is not much more that I can say at this point in time.

Peter Clark (Société Générale): Very quickly on the Functional Materials & Solutions and the raw material trends: It looks like Performance Materials has gone over the hump with the isocyanate price coming back. I see that Coatings is obviously under a lot of pressure. A bit like, I guess, in the OEM, you are under pressure there, on the auto side in particular, also in Construction Chemicals.

I am just wondering when you see the inflection point for this segment as a whole, on the raw material side against pricing? Will it be Q1 next year, do you think, or let's see?

Dr. Martin Brudermüller: A quick answer on this. First of all, let me really repeat: I think, we have done a good job on the pricing side, in several quarters. Yes, I think you are right: You mention the two major points here, Coatings and also Performance Materials as the two divisions who feel that pressure. I think that they will continue on that path in Q4. With this, I think, we will go up, also in terms of earnings. That is what is part of our expectation for Q4.

Peter Clark (Société Générale): Okay. So, the inflection point, you think, is early next year, hopefully early next year?

Dr. Martin Brudermüller: Well, as I said: I think we continuously improved our position here over the recent quarters. We have basically closed the gap. With this, it just continues in that respect. Yes, it's the higher raw material cost which comes in and that should come also at a certain point to an end, that we get more margin and a better pricing power.

2.4 Agricultural Solutions

Andrew Stott (UBS): On the numbers: I saw in the Bayer press release this week that 300 million euros of sales have gone to you. So, I have got the answer on the acquisition effect for Q3 in ag. But on the losses, I was running with sort of 60 to 70 million euros in my head for Q3. I just wondered if you could confirm if that's the ball-park number.

Dr. Hans-Ulrich Engel: Andrew, your question with respect to sales – and then you said: losses – with respect to the Bayer business. You were kind enough to give a figure. Ballpark-wise, that is okay. It is slightly higher than what you suggested.

Patrick Lambert (Raymond James): A question on ag, more looking at Q4 dynamics. Basically, the question is: Are they pretty similar to what we have seen in Q3 in terms of contribution of Bayer's assets and also in terms of what you see on pricing dynamics there, the mix, as you commented?

Dr. Hans-Ulrich Engel: Your question on ag: We definitely expect a stronger Q4. The season in South America will be in full swing. Actually, the indication at the beginning of the season is, as I already alluded to, what we have seen towards the end in Q3. You have seen our comment on the legacy BASF business. So, we have a good start to the season in the southern hemisphere.

Due to the nature – I think you asked also with respect to the acquired assets – of that business expect a similar impact on the ag segment's result as we have experienced it in Q3.

Christian Faitz (Kepler Cheuvreux): Pricing in agro chemicals was up by plus 17 percent. How much of that is underlying and how much of that price push is related to compensation for weaker currencies?

Dr. Hans-Ulrich Engel: Your question with respect to prices in Agricultural Solutions: We have significant price increases. They are to a large extent driven by mix. Overall, the season started a little bit earlier than the season last year in South America. Prices are up significantly, as I said, driven by mix. The currency impact is, as you have seen, at minus 10 percent. You have seen the development of the Brazilian real and the Argentinian peso. The business is to a large extent dollarized, but there is, unfortunately, also a significant impact from FX.

Actually, adjusted for FX, our earnings for the entire business, including the business acquired from Bayer, would have been higher in Q3 than in the prior-year quarter.