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Q4 2022 Covestro AG Earnings Call

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PRESENTATION

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

Welcome to the Covestro Earnings call on the full year '22 results. The company is represented by Markus Steilemann, CEO; and Thomas Toepfer, CFO. (Operator Instructions) You will find the annual report and earnings call presentation on our IR website. I assume you have read the safe harbor statement. With that, I would now like to turn the conference over to Markus.

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

Thank you, Ronald, and good afternoon, a warm welcome also from my side. Looking back to the year 2022, we must clearly admit that the last year was challenging. The effects of the coronavirus lockdown in China during the second quarter caused severe disruptions of logistic chains within China and the rest of the world. Then the war in Ukraine also with a tremendous humanitarian impact. We have and continue to support the Ukrainian people with our donations through the United Nations Refugee Agency and our local country organizations in Poland and Slovakia.

Let me give you an overview of the key financials. Covestro achieved a record sales of EUR 18 billion, driven by significant price increases in order to cope with the tremendous energy and raw material cost inflation. The EBITDA decreased to EUR 1.6 billion, unfortunately, with strong downward traction in the second half of 2022. Nevertheless, we were able to secure a positive free operating cash flow supported by significant working capital savings in the fourth quarter. Despite all these challenges, we returned more than EUR 800 million to our shareholders in form of dividends and share buybacks.

The non-financials are getting more and more important for Covestro and also for our shareholders.

We are proud that we steadily improved our ecological footprint. The greenhouse gas emissions went down by 12% compared to 2020. We added another power purchase agreement for 300 gigawatt hours covering around 30% of the electricity demand of our Shanghai site. The new PPA will increase our renewable share of electricity from 12% in 2022 to 16% to 18% in 2023.

Overall, we are well on track towards our ambitions for climate neutrality by 2035. Also, when it comes to corporate culture, we can see that our employees value our efforts for the society and the working environment. The Top Employers Institute has awarded the title "Top Employer" to Covestro in 3 countries: Germany, China and the U.S., indicating our excellence in people practices.

Covestro has set a very clear target of becoming fully circular. On our way towards the target, we have extended the number of ISCC plus certified sites to 11 sites across the 2 regions, Asia Pacific and Europe. This enables us to offer certified sustainable materials across our product range in both regions. Soon, this network will be expanded to the U.S., where we are currently expecting the ISCC plus certification to arrive early in the second quarter and then making our sustainable offering global.

Turning to Page #3. As I mentioned on the last slide, we are not only progressing the ISCC Plus Certification for our mass balanced raw material value chain. We are also working to make the pass-on of mass balance certification data smarter and securer. In order to achieve this, we founded a joint project together with Circularise and 10 companies along the value chain. Here, we tested a new digital system to validate ISCC Plus data. Advancing digitalization is a key pillar of our strategy and partnering with Circularise represents an important step towards digital certification of sustainability data. Circularise is a leader in blockchain technology for end-to-end traceability of circular solutions, enabling authentication, accessibility, decentralization and encryption of data. The successful project is a key milestone in meeting the increasing demand of the value chain for a digital certification system. It helps to validate material sustainability claims via a system like ISCC. In the future, we expect this to be rolled out to further participants.

Let's turn to Page #4. Another highlight of the quarter was the successful start-up of our new world scale facility to produce chlorine in Tarragona, Spain. The new plant is based upon the highly innovative and energy-efficient oxygen depolarized cathode technology invented by Covestro and its partners. This new plant ensures an efficient and independent supply of chlorine and caustic soda to our MDI production in Tarragona. The EUR 200 million investment will strengthen the European production network for MDI and has created 50 new jobs on site. In 2022, our MDI plant in Spain was already the low-cost plant in Covestro's European network. Please note that Spain has its gas supply coming from North Africa. The expected EBITDA contribution of the reduced cost of chlorine purchases and additional sales of caustic soda and hydrochloric acid is estimated to be a mid-double-digit million euro amount. Compared to the predominantly used conventional chlor-alkali electrolysis, the new process requires a lower voltage resulting in up to 25% energy savings. As such the new plant can avoid up to 22,000 metric tons of carbon dioxide equivalent emissions per year compared with existing processes. The new plant will thus support Covestro's goal of being operationally climate neutral by 2035.

Now turning to Page #5. Let us now have a closer look at the past year, starting with the volume development. Year-on-year, the global sales volume decreased by 5%, mainly driven by weaker demand in the region EMLA and destocking mainly in Europe and to a smaller extent in North America. The region EMLA has seen significant decreases in all industries important to Covestro and was clearly the weakest region. Despite the lockdown situation in the first half 2022, Asia Pacific is showing just a slightly negative volume development. Electro declined significantly and furniture, slightly. However, the stimulus program for auto and transport as well as construction reduced the overall loss with both industries showing growth. Sales volumes in North America were flat with slight decline in furniture/wood being offset by construction and auto and transport.

Looking closer into the different industries, the clear and lasting negative trend in furniture/wood is continuing in all regions. Electro shows especially in the 2 regions, Asia Pacific and EMLA, a continued negative trend. Both industries are affected by a post-COVID decline and a reluctance in private spending due to rising inflation. The picture is, however, mixed for the construction industry. Whilst volumes in Asia Pacific and North America are increasing, the situation in EMEA was negatively affected by the raw material and energy price situation. A globally positive trend is the volume increase in the automotive industry, at least in 2 regions, Asia Pacific and North America namely. Also in Europe, the trend was positive in the fourth quarter, quarter-over-quarter, but not strong enough to compensate for the losses within quarter 1 to quarter 3.

I'm now handing over to Thomas, who will guide you through the financials.

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

Yes. Thank you very much, Markus, and also a very warm welcome from my side to our call. I'm on Page 6 of the presentation, which shows you the sales development. And as you can see, our full year sales increased 13% year-over-year to a record number of EUR 18 billion, which, as I said, is an all-time high for Covestro. And the sales were pushed by 10.1% higher prices and these price increases actually came from both segments. The net volume effect in sales, and that is excluding RFM, was negative 5% year-over-year, and the negative volume growth came almost equally from both segments, Performance Materials and Solutions and Specialties. What you also see in the bridge is a positive strong FX effect of almost 6%, and that is driven by the stronger U.S. dollar and also the stronger RMB relative to the euro.

And finally, you do see a portfolio effect of 2% and that comes from the consolidation of the acquired RFM business because the number is actually equivalent to the EUR 314 million of sales that came from the RFM business in Q1 2022 because remember, the consolidation of that business only started from April 1, 2021.

So with that, let's turn to Page 7 of the presentation where you have the EBITDA bridge. As you can see in the full year 2022, EBITDA almost halved compared to the prior year, and that was caused by a strong negative pricing delta, which built up especially in the second half of 2022. And the low pass-through of energy and raw material cost was, of course, due to the deteriorating supply-demand situation, including the fact that we saw a strong destocking on our customer side. So the total pricing delta amounted to a negative EUR 1.34 billion. You can also see in the bridge that the volume effect in EBITDA contributed negatively, and the volume leverage was negative 40%. On the other hand, FX was positive and there is a relatively small bucket other items.

However, it includes relatively large positions, because on the positive side, there is in a EUR 481 million impact from the release provisions for variable compensation, and there's also in there a positive EUR 86 million from lower cost from the RFM integration and the LEAP restructuring. And against that, you have a significant increases in fixed cost mainly in things like freight, logistics, but also, of course, some salary increases.

So with that, let's go to Page 8. On the upper half of the page, you see that the sales in the second half are significantly below previous year, and that is a strong indication of the economic slowdown. And seasonally, sales were also declining in Q4 because here, in addition, we saw a strong destocking on our customer side. And on the lower part of the page, you see that the EBITDA was actually turning negative in the fourth quarter of the year and that was the first time in Covestro history because the deteriorating industry and also trading conditions and the destocking that I mentioned caused a significant drop in selling prices in a long market environment for all products, but especially, of course, in Performance Materials. So you saw that -- you can see that actually the EBITDA margin is significantly declining through the course of 2022. However, what I would emphasize is that we clearly assume that Q4 marks the trough of the cycle.

So with that, let us go into the 2 segments, and let's start with Performance Materials. Clearly, the segment suffered from the significant negative pricing delta. And while in the first half of the year 2022, we were still able to pass through the majority of higher feedstock and energy prices on solid demand. In the second half, this pricing delta turned largely negative because the demand significantly weakened first in Europe, but then also globally across all the industries, as Markus has outlined earlier. And because of the stronger commodity character of the PM products, and the result is that we're much more exposed to variations in the supply and demand structure. So overall, the PM segment EBITDA declined year-over-year by 63% to EUR 951 million because the supply was outperforming demand, and we had low pricing power and consequently, also the EBITDA margin declined significantly to 10.5%.

Now if we look forward into the year 2023, we are expecting that our sales volumes should stay flat versus 2022 with Q1 and Q2 being still weak, and we're expecting the second half to show a recovery. And I would also say that the first half of this year will still be burdened by idle costs, especially in Europe, for almost all core products, but we're expecting that this situation should then ease in the second half of the year.

So let's turn to Page 10 to Solutions and Specialties. We increased our sales by 13.3%, and that was, therefore, in line with the group level and the absolute EBITDA also increased by 9.9% despite, of course, the recessionary environment conditions. So the segment also recorded sales volumes records. The sales -- segment recorded sales volume decline, excuse me of 6.3% year-over-year and that also is an indication of the difficult economic environment. However, it was compensated by 9.4% increases through pricing and the acquired RFM business, which we consolidated since April 2021 also contributed positively. So overall, the EBITDA margin was flattish year-on-year, and I think this is a clear indication of the resilience of our S&S business.

So let's now turn to the cash flow statement on Page 11. As you can see in the graph on the upper side of the page, we finished the year with a positive free operating cash flow of EUR 138 million, and that exceeds the guidance which we had given in our Q3 call, where we were expecting a free operating cash flow between EUR 0 million and EUR 100 million. And I would also emphasize the first bullet on the upper right-hand side because the free operating cash flow was actually positive EUR 550 million in the fourth quarter of the year, and that is just showing our very successful working capital initiative in the last quarter of the year. And with that initiative, also our working capital to sales ratio dropped to 15.1%. I would also emphasize that we further reduced our CapEx spending by roughly EUR 70 million relative to the guidance, which we had given in our Q3 call, and we came then out at EUR 832 million, thanks to our CapEx agility program.

And the other 2 items that I would pick from the table is, first of all, our income tax will be paid EUR 538 million that reflects largely the unfavorable geographical mix. And last but not least, in the last line item, you see other effects, negative EUR 421 million, that is very much reflecting the bonus payout of EUR 475 million for our successful year 2021, but which occurred as a cash effect, of course, in the second quarter of 2022.

So with that, let's go to Page 12. You have the balance sheet. If you look at our debt situation, I can clearly say that our balance sheet remains strong, despite the fact that our total net debt increased by EUR 264 million versus the end of 2021 and our net financial debt, which increased by EUR 1 billion because -- please consider that in 2022, we paid a record dividend of EUR 3.40 per share, which amounted to EUR 654 million overall. And we also executed on our share buyback program, and we repurchased shares in the value of EUR 150 million between March and June last year. On the positive side, we have a decrease in our net pension liability by EUR 765 million, driven by the increase in pension discount rates both in Germany and in the United States, finally resulting in a EUR 430 million net pension liability.

And if you decompose those EUR 430 million, it consists of pension provisions of EUR 486 million, which are to a small extent offset by a net benefit in assets of some EUR 56 million. So with that, the total net debt-to-EBITDA ratio stands at 1.8x. And what is key for our situation, our strong commitment is that we do remain committed to a solid investment-grade rating.

So finally, on Page 13, I would like to explain some of the onetime effects that you see in our P&L. So first of all, if you look at our D&A for the full year that amounts to EUR 1.35 billion versus EUR 823 million in 2021. And the simple reason is that because of the revised outlook in light of the energy and raw material price increases combined with the strong demand weakness, we do see an impairment test for our units, sPET, sTDI and also some smaller cash generating units in our Solutions and Specialty segment, mainly in Europe, and those impairments amounted to EUR 462 million, as you can see in the table. And secondly, you can also see that our income tax expense amounted to EUR 411 million, down from EUR 566 million 2021. However, that number includes a EUR 255 million write-down of deferred tax assets and tax loss carryforwards.

And if you exclude those, our tax rate would be 26.3%, so in line with the order of magnitude that we had earlier indicated in previous calls. So those extraordinary effects resulted in a net income of negative EUR 272 million, and of course, also negative earnings per share. So now you know that our dividend policy is a payout of 35% to 55% of our net income. It can therefore not be applied, and therefore, the dividend per share will be consequently 0. However, I would also like to emphasize that along with the outcome of 0 dividends, we have taken the decision that we'll also pay out no short-term incentives to the entire workforce of Covestro. Of course, including the Board of Management.

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

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

Thank you, Thomas. Let's turn to Page #14 and take a look at the growth demand outlook for our key customer industries. Our outlook into 2023 expects a further contraction of the global GDP to only 1.5% underlying in the weakness in demand we are currently observing in many industries. Despite exhibiting the most optimistic growth number with 4.6%, automotive is expected to remain below 2019 levels. However, the electric vehicle outlook remains strong with almost 43% growth. The outlook on construction for 2023 is with 0.8%, again, less optimistic and is strongly influenced by the European raw material and energy price situation. The resulting high inflation and increased interest rates are especially hitting the residential sector where the outlook is even negative. After a year of contraction, we foresee a stable trend in the furniture industry. Electro is also expected to further slowdown and demand is only expected to grow at a rate of 2.0%.

However, for the appliance industry, after the negative demand development in 2022, a recovery with a slight growth of 3.7% is expected. This industry is an important consumer of MDI for the insulation part of the appliances.

With this rather mixed picture, let us now come to the Covestro outlook for 2023 on Page #15. The low visibility into 2023 regarding the economic development just outlined on the previous slide and the still unpredictable raw material and energy price situation is a real challenge going forward. We have, as such, decided not to give a guidance with concrete numbers, but rather express our expectations for the full year 2023 on our core KPIs in a comparative manner. The expectation for EBITDA, free operating cash flow and return on capital over weighted average cost of capital is significantly below full year 2022, and here significantly means a double-digit percentage decline. Based on the product margins, Covestro achieved in January 2023, EBITDA would be at EUR 1.0 billion. This mark-to-market EBITDA includes a short-term cost contingency program of EUR 100 million, which should be mainly realized in the second half of this year.

Regarding the free operating cash flow outlook, please keep in mind that we pushed our inventories already to a very low level end of 2022. This said, the further working capital development depends mainly on valuation and incoming payments. We have mentioned already that we expect volumes to be flat, that will lead to greenhouse gas emissions to be in range around full year 2022. However, external factors like grid mix are expected to increase our carbon dioxide by around 400 kt. We strive to fully counterbalance these external factors with internal measurements. In the first quarter 2023, we expect an EBITDA of between EUR 100 million and EUR 150 million. This would be significantly better than the minus EUR 38 million in the fourth quarter of the year 2022. However, we still suffer from low demand in Europe and COVID/Chinese New Year in Asia.

In order to save cash, we have further reduced our CapEx budget to around EUR 800 million. However, we continue to invest into strategic expansion projects, especially in the Solutions and Specialties segment.

So let me quickly summarize on Page #16. We had record sales of EUR 18 billion in the full year 2022, driven by price increases, despite significant weaker demand and lower volumes. At the same time, EBITDA came in slightly below guidance range for the full year 2022, despite a recessionary environment and high energy and raw material prices. Our free operating cash flow of EUR 138 million exceeding the guidance of EUR 0 million to EUR 100 million that resulted from EUR 550 million improved free operating cash flow in the fourth quarter alone. We returned EUR 801 million to our shareholders, comprising dividend payout of EUR 651 million and a share buyback of EUR 150 million. And last but not least, we had an increasing share of renewable energy supply with 12% of renewable energy in 2022 for our electricity demand and that is expected to increase to 16% to 18% in the year 2023.

And now for all the questions that remained open, Thomas and myself are here to answer them. With that, I hand it over to Carsten from our IR Team, who will guide us through the Q&A session.

QUESTIONS AND ANSWERS

Carsten Intveen ***Covestro AG - IR Director***

Thank you, Markus. (Operator Instructions)

And the first question comes from Christian Faitz from Kepler Cheuvreux.

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

You incurred some 76 million impairment losses in Q4 in Solutions and Specialties. I know that, Thomas, you just elucidated those a bit just now. Are there also impairments from the DSM Resins acquisition? And the second question I have is, how is demand out of China at present? Is the post-COVID recovery as strong as hoped for a few weeks ago?

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

Yes, Christian, let me start with the impairment. So again, the vast majority of the impairments, as I said, comes from the polyols and from TDI, and a very, very limited amount refers to, as you said, to a specific business segment in the RFM business that we acquired. Remember, the business that we acquired had various segments, and there's one smaller one, which was also hit by an impairment, but the vast majority of RFM was absolutely unaffected.

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

Yes, Christian, this is Markus speaking. Thanks for your question, and let me allude a little bit to the demand situation in China. We have seen some restocking in February, but if you ask me about would I already see a significant pickup in China in February, no, that is not what we have seen. Nonetheless, we also have to say that there is first slight positive signs in the last couple of days in February and also in March. And also typically, for example, to name one industry, in March the construction season is starting and should help. So even though we do not see yet real pickup or a strong pickup in demand from China, I would expect that in the next couple of weeks, we would see that. And there is at least from my conversations with some of our Chinese colleagues that I had recently, a first indication that it is going to happen, yet I cannot say how strong it will be.

Carsten Intveen ***Covestro AG - IR Director***

The next question comes from Charlie Webb from Morgan Stanley.

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

Maybe just following up on the demand picture. Could you help us understand a little bit if you didn't have the force majeures in the fourth quarter, where volumes would have been across PM would be helpful. And how do you see volumes in Q1 -- within that Q1 guidance given the force majeures are still in place?

And then just second question just around, I guess, the health of the supply and demand for your key commodities. Obviously, the question around demand and I understand that's very difficult to answer. But when you look at the supply, I mean, we're expecting additional supply additions in TDI and MDI in China this year. I suspect polycarbonate is largely done, but certainly, the utilization rate is now quite low. So just trying to understand how do you see the current balance across those commodities looking through this year? Because it does still seem like we're still in a wave of supply additions regardless of where the demand comes spectrum or not. That might dampen any sort of recovery for '23. Just on to gauge your view on that.

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

Charlie, this is Markus speaking. So first and foremost, thanks for the question, and it is one of the questions that is really on top of our heads. Also, when we try to look into this year and also when we looked into the guidance for this year. So you're absolutely right. We were dealing in the fourth quarter of last year with quite a number of force majeure, and those are continuing into the first quarter. And that is, for example, our TDI unit in Dormagen, which is only running maximum at half capacity, our Uerdingen polycarbonate as well as MDI facility in Uerdingen impacted basically by the chlorine supply chain that supplies all of the 3 mentioned assets. So it is not only but strongly , let's say, focusing on Europe when we talk about respective supply topics with regard to force majeure that we have. That definitely has led also to the inability to supply more, and that also has partially contributed to the volume development.

But let me also be clear, the volume development on the one hand is limited by our supply situation, but it is also limited and that also continues into the first quarter by still a challenging demand environment. And here, and I alluded based on Christian's question a little bit to that, the demand situation is particularly, let's say, challenged in Europe and challenging -- and continues to be challenging in Europe. And we still have not yet seen major positive signs from an improvement in demand in China. Whereas the U.S., that was, I would say, slightly -- flat to slightly negative. So that is how we have started. So baseline after a little bit more detailed explanation. The majority of decline in demand is really coming from weaker demand or sales from our side is coming from weaker demand and not, let's say, from our force majeure situation.

So for Q1, therefore, we expect, in total, a mid-teens volume decline, and yes, that's what we currently expect. If we talk about the balance or let's say, supply-demand balance, TDI was very strongly down in a year talking market for TDI in 2022 by minus 7%. But let's not forget, in which position Covestro is in those markets. We are normally first ones to be in when a crisis comes, but we're also the first ones to be out. That means a very fast rebound and very quick recovery is possible. So that is how I see it. If you want to have, let's say, a guess on MDI, construction is still, let's say, as we said, expected to be slightly positive for the full year. However, we have not yet seen that there's a pickup, as I said, with regard to China. We expect the pickup to happen now in March because that's normally when construction season starts. And yes, that's the current situation.

I hope it's helpful. It's a very mixed bag, honestly speaking, and we try to provide you with as much insight as we have, but we're also trying to figure out what is currently going on.

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

Got it. That's helpful. If I could just follow up quickly in terms of the supply and demand. I mean are you surprised to sort of see Chinese peers and competitors adding capacity into the MDI at these current levels because we still have some pretty big additions this year.

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

Well, first and foremost, there is -- and we have always been very clear -- for all the, let's say, more commoditized parts in our portfolio and particularly for MDI, a clear mid- to long-term demand growth. And take MDI, we are convinced that growth rates structurally are still in the area of 4%, 5% to 6%. Next to the fact that we have seen, let's say, the challenges, but do not -- or please do take into consideration that we're talking about energy-efficient buildings. We talk a lot about retrofitting needs. Yes, we have seen now due to somewhat, I would say, pre-consumption patterns during the corona pandemic in -- with regard to furniture also a stronger decline in TDI. But that is not a structural challenge, it's more a cyclical challenge that we are facing. And with regard to destocking, we think that we will see the end of destocking latest by Q2, and therefore, Q3 rebound is possible. So having said -- and you referred to additions in supply, I mean, let's also be clear, and we have been clear in different context in the last couple of years:

Once you decide to invest, you invest and then the best way to build as effective and efficient as possible is just to push through and build as quick as possible. Stopping and accelerating makes investments extremely costly, and that's why exactly what you see right now is just a consequence of decisions that have been taken a year or years ago. And the respective companies also see, as we do, obviously, the structural growth opportunities in those markets. The major additions you are talking about are coming solely from Wanhua in China. And as we have always stated from our observation, that is a player who is very price disciplined because they have the largest market share. That means they have the most to lose if they're not very disciplined on that. Also here, I hope that gives you some flavor.

Carsten Intveen ***Covestro AG - IR Director***

And the next question comes from Mubasher Chaudhry from Citigroup.

Mubasher Chaudhry ***Citigroup Inc., Research Division - VP***

Just one on mark-to-market EBITDA. Are you able to comment how that has developed for the month of February? And what the mark-to-market would look like based on your base case volume outlook for 2023? That's the first question. And then second question, looking through kind of the energy costs have come down and they still remain elevated level compared to historic levels, I just wanted to get your comments on the mid-cycle EBITDA for Covestro or what you think is achievable? I know you talked about, I think, about EUR 2 billion, EUR 2.5 billion historically. I just wanted to confirm whether that's still valid or that view has changed given the higher energy prices in Europe?

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

Mubasher, this is Markus. First, thanks for your question, and let me talk a little bit about the first part of your question, the mark-to-market EBITDA. Currently, we do not know yet the February EBITDA. So we normally know that at the seventh/eighth working day of the following months, and we are not yet there, we would assume that it will be slightly up in this context from today's perspective. And that's normally how we calculated this, we just take the respective margins and multiply that respective margins in the given months, let's say, flat forward to the volume assumptions. So our base case is that they have flat volumes compared to last year. So if you take a flat volume development with the respective product mix and assume January margins to be applied for the full, let's say, following 11 months, then you would come to that EUR 1.0 billion. And as I said, for February, we would expect margins to have slightly -- as I said, slightly improved in this context.

With regard to the mid-cycle EBITDA, we remain confident that the EUR 2.8 billion, let's say, are fully confirmable. We do not see any structural problems, but as I alluded earlier to rather short-term cyclical problems. And let's not forget, overall, we are now in year #4 of the coronavirus pandemic and year #2 of the Russian aggression against the Ukraine. And therefore there is the low demand that comes from that. But on the other hand, we remain the low-cost producer in the regions and especially, in Europe. So all-in, the EUR 2.8 billion are fully confirmed as mid-cycle EBITDA. And at the same time, we are in short-term cyclical turbulences, and we do not see structural problems in the markets.

Carsten Intveen ***Covestro AG - IR Director***

And the next question comes from Georgina Fraser from Goldman Sachs.

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

I've got 2 questions. The first one is on your volume outlook, and it's kind of in 2 parts. You're using the IHS GDP forecast of 1.5%. Our in-house at Goldman is 2.4%. I was just wondering why you would expect your volumes to undergrow GDP this year when they already did last year? And then another kind of similar question. Markus, you've been at Covestro for more than 20 years. Have you ever seen volumes down mid-single digits and then the subsequent year was only flat? And then my second question is, any comments that you can make around how the competitive landscape in European TDI is evolving on the back of BASF's announcement?

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

Georgina, this is Thomas. So let me start with the volume question. And first of all, of course, we don't have a crystal ball, so we took the 1.5%. Let's hope that Goldman Sachs is right and the 2.4% materialize. But your question was more regarding our volumes. So the factors that we have baked in is that we are still seeing some destocking in the first quarter of this year, and we're also still struggling with some force majeures that will also not only burden Q1, but also at the beginning of Q2, and only then should we see some improvements. And then, of course, you will see some growth because the comps are getting easier in the second half of the year. But the reason why we're not significantly outgrowing that, but rather being flat is that we're still struggling with, as I said, destocking and some internal problems that we have to resolve, specifically in our North-Rhine Westphalian assets.

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

Yes, Georgina, this is Markus speaking. Very good to hear you, and thanks for your questions. And as you directly addressed the question to me, and I have to say, I'm not 20 years with Covestro, even though I might look that old already, I'm actually 24 years with the company and only joint Covestro then back in 2004. So there's still one year to go just to be very precise on the data. But your question was targeting did I ever see in that, let's say, 19 beautiful years 2 sequential years with negative or, let's say, at least one negative and then flattish volume. I would say, yes, kind of, but is it very likely. No, not necessarily. But I think Thomas has made it very, very clear why we have actually given that you could call it conservative guidance. So yes, so that is exactly how I would interpret and answer to your question, yes.

And then on the competitive situation, particularly in TDI, how do I look at the picture? I do not comment on what our colleagues up the Rhine River in Ludwigshafen have said, but the overall number is that with that capacity at one point in time not being there in Europe anymore, it would mean that we have 36% lower European capacity on TDI and 9% lower global capacities. We were and therefore, also remain the low-cost producer in Europe, especially given that the gas phase technology that we are using has 60% less energy consumption than the other processes that are used in the industry. And with that, also Europe is coming from a net exporter position into a net importer position. And we also believe that the TDI market, next to all the short-term turbulences, structurally would still grow with a low single-digit rate. So that's how I currently look at the TDI situation. I hope that is a comprehensive answer to your 2, 2.5 questions.

Carsten Intveen ***Covestro AG - IR Director***

And the next question comes from Isha Sharma from Stifel.

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

I just have 2, please. First, could you help us reconcile the mark-to-market of EUR 1 billion and the Q1 guidance of EUR 125 million in that context? And also the moving parts for free cash flow, please, after you already saw such a strong working capital release in Q4. The second question would be, again, on the free cash flow guidance. Have you considered canceling the share buyback because if we look at the mark-to-market EBITDA and then take the free cash guide, are you comfortable with that kind of leverage level?

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

Yes. Isha, this is Thomas speaking. So first of all, I would say, the mark-to-market and also our Q1 guidance are fully consistent. And the way how to bridge this is simply that we are still seeing depressed volumes in Q1, and I'm reiterating myself, we're still seeing significant destocking from the market. And I admit it takes longer than what we had expected, but we clearly see that this is not end consumer demand, but this is a supply chain that squeezes out the volumes. And secondly, we're still struggling with our force majeures, as I said, specifically in our German assets. So those things should get significantly better over the course of the year. And therefore, I would say, the volume development that we're currently seeing multiplied with the margins as of January is fully consistent with both the EUR 1.0 billion mark to market and the midpoint EUR 125 million in the first quarter of the year.

Secondly, to your question, the share buyback. It is absolutely still in place as a program, but I think we've also been very clear that we're currently not buying in the market because we need to see a little bit more clear how the year is going to unfold. I said also on the call that preserving the strength of the balance sheet and being absolutely sure about the rating is paramount for us, and therefore, we do need a little bit more visibility into the year before we can take up the share buyback, but the general commitment is absolutely unchanged. Looking to Ronald, any other -- I think those are the questions.

Carsten Intveen ***Covestro AG - IR Director***

And the next question comes from Chetan Udeshi from JPMorgan.

Chetan Udeshi ***JPMorgan Chase & Co, Research Division - Research Analyst***

I wanted to follow on the previous comment on structural volume growth because unless my calculation is wrong, I was just doing my math for the last 5 years, 6 years and Covestro's volumes have been rather flattish on average, no CAGR now starting from 2017. And so I just wanted to challenge this perception that you give us, which is that the underlying industries that you are exposed to have strong growth prospects because we don't seem to have seen it in Covestro's volumes in the last 5 to 6 years on a CAGR basis. I'm just curious, do you think there is a reason why that structural growth might be -- might have weakened? I don't know whether it's the penetration tailwind becoming less pronounced then was the case in the prior years. But just curious whether those assumptions are still relevant given what we've seen in the last 5 years.

And just in that same sort of related question is, you guys, at some point in the past, used to give the EBITDA per ton benchmark. And I'm just curious if I had to sort of do that same calculation today on EUR 1 billion EBITDA, how would that look? Because I would suspect, that will look much weaker than we've had for long-term average. So again, going back to the same point, like the industries too hoping for too much growth and overspending on capacity. Just curious what your thought process are.

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

Chetan, this is Markus speaking. I don't know if it's a good answer or a better answer, but you judge on that. The volume growth that you see is 2021, particularly. I mean, 2020, we had a very special year because that really was first year of the corona crisis and that is a different animal, but 2021 and also 2022, and we have alluded to that in previous answers in this call today, there was low demand -- cyclical low demand. And on top of that, production problems, and that is very Covestro-specific. So that does not reflect the overall market. We have a very high visibility on market growth as there is good industry data available, and therefore, I was making also the statement earlier that we see the structural growth path to be fully intact. What we see is that we have regional shifts. For example, Asia Pacific is growing at a much faster pace than the U.S. and then particularly, then Europe.

And also that meanwhile the markets and the total overall volumes have shifted from Europe as well as from partially the U.S. into Asia Pacific in terms of absolute volume growth. Nonetheless, we will get tighter supply/demand in MDI in the not-too-far future. And therefore, I would say, the same thing will also happen in TDI now even faster than we originally expected, given that we just have seen that one of the larger players has decided or at least announced to shut down 9% of global market capacity in TDI. So in short, it is unfortunately quite Covestro specific and hence not, from my perspective, at least an indication of structural growth problems in the market.

Chetan Udeshi ***JPMorgan Chase & Co, Research Division - Research Analyst***

And can I follow up quickly on chlorine. What is exactly the problem with chlorine production? Is it -- I think you produce your own chlorine. So is it something got to do with the Covestro production system having some issues?

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

Yes, this -- okay, let me call it that way. There is an issue with the piping in the chlorine plant and that was due to some repair works that has been conducted. And that repair works that have been conducted led then later on to, let's say, a mechanical disruption of the system, and that then has caused us to figure out that while the pipes were replaced, there was obviously a material issue with the pipes. And to replace that and to make absolutely sure that this never happens again, we are currently on the entire value chain that delivers those pipes that is actually also using those pipes and repairing those pipes does not make any mistake anymore. And that's why we are currently in that situation.

Carsten Intveen ***Covestro AG - IR Director***

The next question comes from Markus Mayer from Baader Bank.

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

Yes. Three questions from my side as well -- no 2 actually as one was already asked. I only ask small question from the balance sheet side. I was wondering why the pension provision in the fourth quarter went up only EUR 60 million, but versus the third quarter. But given the high interest rates, this was nevertheless something which (inaudible) strange. Maybe you can quantify and clarify on this. And then also on the RFM integration. This is running as planned or basically, is it already done? And are the synergies landing as planned? Second question.

Yes, and then the third question is, I understand the new point on the moving parts on your free cash flow bridge, but what I do not understand is, why -- of course, you have seen significant net capital reduction in the fourth quarter, but nevertheless, looking at the net working capital at the year-end of 2022 and comparing with this years like 2020 and 2019, we have prices for most of your products have been higher than they are right now. Then I still don't get it why you do not have baked them net on capital reduction in your free cash flow guidance.

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

Thank you. This is Thomas. Maybe Markus, I'll try to answer those questions. So first of all, the slight movement in pension provisions simply has to do with our U.S. pensions, where the interest rate slightly decreased in the fourth quarter of the year. So that is the main driver for that. To your second question, with the RFM integration, I would even say that we are slightly ahead with respect to timing perspective. So we fully confirm the synergies of the EUR 120 million. We also fully confirm that 2/3 of that will be cost driven. And as I said, we are even slightly ahead of the implementation path with respect to the realization. And then lastly on the working capital topic. So I mean, remember, we have first of all, reduced our working capital by close to EUR 900 million over the course of the fourth quarter and that was mainly driven by a reduction in kilo tons. So yes, there might be further potential if valuation goes down. You alluded to the prices, but of course, our inventories are valued not by market prices, but by the production cost.

So we're still sitting on relatively high working capital in terms of production costs and input costs. And that's a difference relative to the year that you were citing, 2019. Production costs were way lower while maybe prices, as you correctly said, were at the same level. So I think that is, of course, a difference when you look at the working capital development if you compare those 2 years.

Carsten Intveen ***Covestro AG - IR Director***

And the next question comes from Geoff Haire from UBS.

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

Can you hear me?

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

Very well.

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

I just had one question. Just on the dividend policy. Obviously, you put that in place last year. Given that EPS, given where your mark-to-market EBITDA is going to be negligible this year, are you willing to step outside the 35% to 55% payout ratio?

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

Well, I would say, Geoff, in general, of course, we stick to our policy, but we're not totally religious to it. So if there is a situation where the circumstances speak for an exception and there are good reasons for that, then of course, I would say, we would not blindly stick to a policy that is in that situation potentially not convincing. That would be my answer to this one.

Carsten Intveen ***Covestro AG - IR Director***

And the next question comes from Laurent Vergnault from CreditSights.

Laurent Vergnault ***CreditSights - Analyst***

. It's mainly about leverage. And so I understand the commitment to your solid investment-grade rating, but the possibility of the gross leverage exceeding 3x. I don't know if you had any discussion with Moody's recently and what kind of flexibility Covestro has to either avoid or reduce releveraging risk you see any potential risk of downgrade.

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

Yes. Laurent, this is Thomas. So I can clearly say, we had numerous discussions with Moody's, and the good thing is, they have been with us since 2015, and they fully understand the nature of our business. And they do, therefore, look through the cyclicality of the business from a rating perspective. That also manifests itself then in situations where the leverage is very, very low, they would actually also not go for an upgrade because they know that there is some cyclicality in the earnings pattern. And therefore, they do give us also a significant grace period in years where the -- I mean the formal numbers would then slightly go up. And on top of that, I think what is very important with respect to the rating is that they do see the actions that the management is taking to preserve the rating and not always to the pleasure of our investors.

We did take those actions also with respect to the dividend decision and with respect to the fact that we put the share buyback at least to a short-term pause. And therefore, I feel very confident that the investment-grade rating stands on very solid ground.

Carsten Intveen ***Covestro AG - IR Director***

And the next question comes from Jaideep Pandya from OnField Research.

Jaideep Pandya ***On Field Investment Research LLP - Analyst***

Yes. The first question is really on your CapEx. So you've basically been spending around EUR 800 million to EUR 850 million. Just want to understand how sustainable is this? Because obviously, you're not doing the MDI plant now, and you keep having an odd production issue here and there. I'm not talking about weather-related (inaudible) kind of (inaudible). So I just want to understand if you were to actually put a 5-plus year view growth on the table? Is the underlying CapEx [EUR 800 million to EUR 850 million]? Or is the underlying CapEx EUR 1 billion plus? That's my first question.

And the second question really is around your Solutions business. So could you just tell us what are your volume expectations this year? Because as I understand, your pricing always has a bit of a lag. And with raw materials going down, price versus raw materials actually should be positive. So I'm trying to understand, are you expecting negative volumes and therefore, guiding for flattish EBITDA for this division?

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

Jaideep, thanks for your question. This is Markus speaking. So let me first allude a little bit to the CapEx. You may indicate that we are underinvesting in reliability of the plant. Let me rest you assured that we spend about EUR 450 million maintenance and that ratio is slightly. And I'm just saying that slightly increasing year by year, simply because there is more assets that we have to maintain, and there's also inflationary tendencies. But it is not, let's say, a big issue, but we are spending the money to keep our plants in very good order. What we have just described is a very unfortunate combination of aa, let's say, wrongly supplied material choice once we did the repiping as part of the maintenance effort in our chlorine plants with huge impact because chlorine is part of our backbone. That means this little, may I call it, let's say, mechanical failure, a material failure in our chlorine plants has affected all major, let's say, products, polycarbonate, MDI and TDI at North Rhine Westphalia 3 large sites.

So what you're referring to was a small, if I may say, effect with huge impact but is not related at all, let's say, to any under-maintenance or under-spending with regard to CapEx for maintenance. Given that, let's say, a figure of around EUR 450 million even under the circumstance of EUR 800 million of CapEx, let's say, that reduced level for this year, we have still EUR 350 million for expansion, and that expansion happens mainly in the less capital-intensive solutions and specialty segment. So bare bone spending, that's the bottom line, would only be maintenance, but that would really take several bad years. So EUR 450 million is from our perspective in terms of maintenance, the bare bone rock bottom.

With regard to your volume question, the Solutions and Specialties segment is hit by a negative product mix across that segment. For example, the Coatings Adhesives business entity is currently stronger down. Nevertheless, given the challenged demand outlook with regards to a round last year should be seen as a strength. So we can defend to sell, and we also can defend our margin profile. But as you look into the, let's say, full year, you could also see that we will have a slower start also in the first quarter in the Solutions and Specialty segment. And then over, let's say, the 3 following quarters to come, we will also see a sequential increase for sure. Fourth quarter is always a different animal, but Q2 should be up, Q3 should be up, and then let's see how Q4 develop. As I said in a normal year, Q4 is normally a weaker quarter. But as we are on from our perspective today, let's say, positive trajectory with regard to the overall demand pattern, maybe Q4 is even coming as a surprise.

Carsten Intveen ***Covestro AG - IR Director***

There are no further questions at this time. So handing back to Ronald.

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

Thank you all for participating, and thank you for your questions. And we will see you obviously next time for the Q1 conference call or in between. And if you have any additional questions, don't hesitate to call the IR department. Thank you and bye-bye.