Dow CEO, COO & CFO Analyze 2nd Quarter Earnings

Second Quarter 2017 Earnings
The Dow Chemical Company
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Quarterly Earnings Conference Call/Webcast with
Investors, Financial Analysts and the Media
Remarks By:

Andrew N. Liveris, Chairman and CEO
Jim Fitterling, President and COO
Howard Ungerleider, Executive Vice Chairman and CFO
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N. Sheorey

Good morning and welcome to The Dow Chemical Company's second quarter earnings conference call. I am Neal Sheorey, Vice President of Investor Relations.

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On the call with me today are Andrew Liveris, Dow's Chairman and Chief Executive Officer, Howard Ungerleider, Vice Chairman and Chief Financial Officer, and Jim Fitterling, President and Chief Operating Officer.

We have prepared slides to supplement our comments in this conference call. These slides are posted on our Investor Relations Financial Reporting page. You can also access the slides through the link to our webcast.

I would like to direct your attention to the forward-looking statement disclaimer contained in both the press release and in the slides. In summary, it says that statements in the press release, the presentation and on this conference call that state the company's or management's expectations or predictions of the future are forward-looking statements intended to be covered by the Safe Harbor provisions under federal securities laws. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of principal risks and uncertainties which may cause actual results and events to differ materially from such forward-looking statements is included in the section titled "Risk Factors" in our most current annual report on Form 10-K.

In addition, some of our comments reference non-GAAP financial measures. A reconciliation to the most directly comparable GAAP financial measure and other associated disclosures are contained in our earnings release and on our website.

Unless otherwise specified, all comparisons presented today will be on a year-over-year basis. Sales comparisons exclude divestitures and acquisitions. EBITDA, EBITDA margins and earnings comparisons exclude certain items.

I will now turn the call over to Andrew.

A. Liveris

Thank you, Neal, and good morning. If you could look at slide 3, our results in the second quarter further extended Dow's unparalleled track record of performance.

The strategy we put in place more than a decade ago continues to prove its ability to deliver short- and long-term, sustainable shareholder value under all business conditions.

Here are the highlights from the quarter. 19 consecutive quarters of EPS growth, nearly 5 years, only two other companies in the Fortune 100 can claim such a consistent track record of bottom-line growth, and no other company in our industry. 15 consecutive quarters of volume growth – nearly 4 years. Our third consecutive quarter of all-time record EBITDA. And broad-based top-line growth, as sales grew in every segment and in every geography, I'll come back to this in a minute.

And we have achieved this while also driving the most comprehensive slate of growth investments in our industry, which are now on the cusp of becoming earnings tailwinds.

In the Middle East, our Sadara joint venture has now achieved commercial operations at 25 of its 26 production units. On the U.S. Gulf Coast, startup of our ELITE enhanced polyethylene unit and our new world-scale cracker are imminent. And we advanced our proposed merger with DuPont, achieving conditional regulatory clearances; announcing the Board of Directors for DowDuPont; and reaffirming our expectation to close in August.

I want to take a moment to expand on Dow's strong top-line performance in the quarter.

We grew organic sales 8 percent in the quarter, with gains in every operating segment, and in fact, in nearly every Dow business, as well as in every geography.

This is a testament to the increasing consumer-led demand that we continue to see for Dow products around the world, driven by our strategic mix shift to downstream high-growth end-markets that are growing in a slow growth world, markets such as packaging, transportation, infrastructure and consumer goods.

Growth was particularly strong in key regions of North America and Europe, where we grew sales at greater than 2x GDP, as well as throughout Asia Pacific, where new product from our Sadara joint venture is enabling us to meet the needs of the growing middle class.

Simply put, Dow again delivered in the second quarter, as we have these last many quarters, and we are entering merger close from a position of strength. I will spend some time later on the call discussing the exciting future we see as we embark on the next steps in our evolution into the world's leading Materials Science company.

But first, I will turn the call over to Howard and Jim to discuss our quarterly performance.

In addition they will describe the status of our growth projects, and in response to recent questions on the value creation of our integrated portfolio, in both assets and markets, Howard will reveal new information on how the Silicones platform has been a hand-in-glove fit to the Dow portfolio. And Jim will discuss and show the value embedded in our integration. We have not shared this information before, but feel it's time we did show these numbers to you, our owners.

First, the quarter. Howard?

H. Ungerleider

Thanks, Andrew. Turning to Slide 6 and a summary of our results.

We delivered earnings per share of $1.08, which represents our highest second quarter EPS since 2005.

Sales grew to $13.8 billion. Volume and price both grew in all geographies for the second consecutive quarter.

Price rose 5 percent as we drove pricing initiatives across many businesses in response to value in use as well as higher raw material costs.

Volume grew 3 percent reflecting gains in all segments with notable strength in our downstream, consumer-led sectors.

EBITDA increased 12 percent to $2.8 billion, with increases in all segments except Performance Plastics. Key earnings drivers in the quarter included broad-based consumer-driven demand; higher prices; improved mix, including the benefit of new product introductions; and cost savings from both productivity and cost synergies.

These gains more than offset higher feedstock costs, commissioning and startup expenses at Sadara and in the U.S. Gulf Coast, along with planned maintenance spending.

These commissioning costs and impact of maintenance activity was in-line with our modeling guidance, and will continue in the third quarter. I encourage you to review the updated modeling guidance in the appendix for more details. After we close the DowDuPont transaction, we do plan to provide additional info to assist in building out your models.

Moving to our business highlights, starting on slide 8.

Despite a persistently soft Ag market, Dow AgroSciences continues to deliver. EBITDA was $326 million on strong demand for our novel Seeds and Crop Protection technologies and on benefits from lower operating costs.

Seeds delivered double-digit volume gains, led by higher demand for corn seeds in Latin America and demand for cotton seeds in North America. Our highly successful launch of ENLIST cotton in the quarter was a significant driver of the increase in demand. We also achieved import approvals, specifically in

China, enabling the full commercial launch of ENLIST corn seeds in the U.S. and Canada for the 2018 growing season.

Crop Protection volume increased on higher demand for herbicides and insecticides, which more than offset lower demand for fungicides. Dow Ag's robust crop protection innovations were again a key driver of growth in the quarter, with notable contributions from Arylex broadleaf herbicide; Isoclast insecticide; and new corn herbicide formulations in North America.

The business also benefited from accompanying sales of ENLIST DUO herbicide resulting from the launch of ENLIST cotton seeds. Farmer reaction to ENLIST DUO has been overwhelmingly positive, based on its highly effective volatility and drift profile when compared to traditional 2,4-D and glyphosate.

We continue to expect $600MM of additional revenue from our new seeds pipeline by 2020, of which ENLIST is a key driver.

Moving to Consumer Solutions on slide 9.

The segment delivered record quarterly EBITDA of $541 million and its eighth consecutive quarter of earnings growth. Volume gains were reported in all businesses and all geographies.

Dow Automotive achieved record second quarter EBITDA and its 17th consecutive quarter of volume growth. The business continues to outpace the automotive end-market, largely due to strong demand for our innovative platform of structural adhesives.

Consumer Care reported volume growth in all geographies, as well as double-digit gains in pharma and food applications.

Dow Electronic Materials delivered its 8th consecutive quarter of EBITDA growth and an all-time record EBITDA. The business drove double-digit volume gains in most geographies, with strong demand in semiconductor, OLED and printed circuit board applications. Electronic Materials also had a one-time benefit from the sale of Dow's share in a non-core joint venture.

With the addition of our silicones platform, we were also able to achieve new commercial wins and market share gains across each of our Consumer Solutions businesses.

Infrastructure Solutions, on slide 10, achieved record EBITDA of $556 million, driven by volume growth, the contribution from Silicones, and a one-time benefit from a building sale resulting from the integration.

Dow Building and Construction delivered volume gains on strong demand for methyl cellulosics and acrylics-based construction chemicals.

Dow Coating Materials reported higher sales, as price increases gained traction in most geographies.

And Performance Monomers reported price and volume growth on opportunistic sales of acrylates and methacrylates.

On slide 11, Performance Materials and Chemicals delivered EBITDA of $347 million as broad-based sales gains in all businesses and geographies more than offset the impact of higher raw material costs.

Polyurethanes sales grew double-digits, and the business recorded its 15th consecutive quarter of volume growth, led by strong demand in downstream, higher-margin systems applications.

Industrial Solutions sales increased in all geographies on pricing momentum and higher demand into lubricants, crop defense and electronics processing applications.

Chlor-Alkali and Vinyl sales increased, led by double-digit gains in caustic soda and vinyl chloride monomer in EMEAI.

On slide 12, Performance Plastics achieved its fourth consecutive quarter of year-over-year sales growth. EBITDA was $1.1 billion, down from a second quarter record of $1.2 billion in the year-ago period. Price gains were more than offset by increased feedstock and energy costs, commissioning and startup expenses and the impact of higher maintenance activity, all of which were in-line with our modeling guidance.

Packaging and Specialty Plastics delivered record second quarter sales volume and the 12th consecutive quarter of volume growth, led by double-digit increases in EMEAI and Asia Pacific, partially supported by Sadara volume.

Elastomers achieved volume gains, led by a double-digit increase in EMEAI on demand growth in automotive and infrastructure applications.

Electrical and Telecommunications volume declined as the business was impacted by turnaround activity.

Let's now turn to an update on our value drivers, beginning with slide 14.

Throughout our nearly five years of delivering consistent bottom-line growth and increasing shareholder returns, we have also continued to build for our future.

Dow's comprehensive growth investments are fundamentally rooted in the key pillars of our business model. Aligning to our key chemistries and value chains, where we hold industry-leading positions, leveraging our world-class innovation expertise across technology platforms to serve our core materials science markets, combining scale and operational excellence, optimizing value through operational reliability as well as feedstock flexibility and enhancing our global reach, to capture consumer-driven demand and grow where growth exists.

On slide 15, I will start with the successes we have achieved in our first full year following the Dow Corning ownership restructure.

The silicones integration continues to exceed all of our expectations. First, we have reinvigorated the financial performance of the business. Prior to the restructure, Dow Corning's revenue and earnings had plateaued. In the past year, we have accelerated the business's bottom-line growth by double-digits while at the same time broadening the addressable market for silicones; expanding its customer base; and bringing Dow's "sell-out/sell-up" mindset into its operational discipline.

We have also significantly outperformed on the cost synergies. After raising the initial target to $400 million, we achieved the full two-year run-rate in just 10 months as you know. And today, I am pleased to report that we have uncovered even more opportunity.

As a result of implementing Dow's unique business model and work processes into and across the silicones platform, we now see a total cost synergy opportunity of more than $650 million across Dow, up more than 50 percent from our previously stated target. We expect to achieve this higher run-rate by the end of 2018, and today we are already at a run-rate of more than $500 million.

We are also making strong progress to accelerate growth utilizing our silicones platform. In addition to our $100 million growth synergy target, we now see more than $500 million of additional Dow-enabled bottom-line growth across the enterprise, driven by volume and mix benefits from integrating silicones into the Dow portfolio and going narrower and deeper into our four market verticals.

Taken together, these cost and growth drivers greatly enhance silicones' profitability. We now see EBITDA increasing to more than $2 billion at full run-rate by the end of 2019 – more than double our initial projection.

The vast majority of these benefits are exclusive to Dow – uniquely enabled by our capabilities, infrastructure, scale, value chain focus and application development leverage at the customer interface.

Turning to slide 16, our successes to date have been achieved due to the strategic hand-in-glove fit between Dow and our silicones platform – not just in our markets and applications, but in the very essence of our business model and our asset footprint. Silicones as a platform is rooted in integration and innovation. It is, at its core, an organic chemistry capability.

And as you can see on this slide, the manufacturing is a multi-step, asset-intensive process. Our silicones manufacturing is back-integrated into the key building blocks, including silicon metal, which are used to produce basic silicones or siloxanes at key sites globally. These are then fed to our downstream systems and finishing units, often at the same integrated sites, to produce high-value formulations in our core materials science markets of packaging, transportation, infrastructure and personal care.

The end result is a financial profile of the silicones platform that is nearly identical to Dow's, especially now that we have captured cost synergies as we have integrated silicones into the Dow business model.

The integration of silicones goes beyond assets to the growth side of the equation, as shown on slide 17.

Here you see why we are so excited about this transaction. The hand-in-glove fit with Silicones is a growth accelerator. We are already seeing this, as the silicones platform captured demand growth at nearly 2X GDP in 2016 in the first half of this year.

Going forward, the value of our combined chemistry platforms, broader channels to market and multiple touch points throughout the value chain is expected to enable $7 billion of addressable market expansion in our key market verticals through 2020. This is why we are so confident in continuing our top-line growth trajectory and further extending our leadership positions.

No one in our space can match the deep capabilities, differentiation and materials science expertise that we now bring to bear in these markets.

But the benefits do not stop at our growth or cost synergy capture. We have also started to capture benefits from key operational improvements that have been released as a result of being integrated into Dow's business model – from improvements in safety performance to working capital efficiencies to increased productivity. All of these improvements enhance our unique ability to drive efficient earnings growth and deliver the step-change in financial performance I showed on the last slide.

To sum it up … the first year of the integration has gone faster and better than even our highest expectations. The transaction was immediately accretive, and the progress we continue to make will further enhance shareholder value in ways that are truly unique to Dow.

With that, Jim will cover the rest of our value drivers.

J. Fitterling

Thanks, Howard. Let's turn to our Sadara joint venture on slide 18.

I cannot stress enough the magnitude of progress the Sadara team has made since our last earnings call. The JV brought online nine additional units, including PO/PG, Polyols, Amines and Glycol Ethers. Year-to-date we have started up 21 units, and today Sadara is commercially operating 25 of its 26 production units, with the final unit preparing for startup.

Product marketing and distribution have gone well, and the work we've done to establish channels-to-market and generate customer excitement is paying off. In the second quarter, Sadara sold nearly half a billion pounds and was a tangible growth driver in our Performance Plastics franchise. All plastics units as well as the cracker have demonstrated at or above their design capabilities.

Looking ahead, we still see all of 2017 as a startup year, as the units continue to increase production rates, optimize the integration reliability, build inventory and qualify products with customers. And the JV remains on track to achieve the financial targets we set out for this year.

Moving to the U.S. Gulf Coast, on slide 19.

We have completed construction of our new world-scale ELITE enhanced polyethylene train, and startup is imminent. Once online, we will ramp toward full prime production and begin qualifying material with customers, and replenish our supply chain in the Americas. You should expect this unit to deliver earnings contributions starting in the fourth quarter.

Startup of our new Tx-9 facility, the ethylene cracker, is also imminent. In fact, we have begun to introduce hydrocarbons to the unit. Once online, the cracker will ramp as derivative production increases throughout the third quarter.

The next unit online will be our new tubular high pressure low density polyethylene facility in Plaquemine, which is the same design as the one in Sadara. This train is on track for mechanical completion in the fourth quarter, and is expected to begin contributing to earnings in the first quarter of 2018.

These new facilities will build on the successes and benefits of those investments we have already completed.

The recent expansion of our LA-3 cracker has been a huge success. This project increased the ethane cracking flexibility of the unit while maintaining our propane and naphtha flexibility. We've tested the full capabilities of the unit and are already seeing results. This past quarter Plaquemine achieved its second consecutive quarterly ethylene production record. And for the first time ever, the site produced over half a billion pounds of ethylene in a single quarter.

Our PDH unit also delivered another quarter of bottom-line benefits. We recently took the unit down for planned maintenance after more than a year of operations to implement best practices and make improvements to ensure long-term reliability. PDH is back online and ramping to rates. We continue to make improvements to the process to take this technology to higher reliability levels.

And finally, we continue to put in place future growth drivers. Last quarter we announced the next phase of comprehensive investments, approximately $4 billion over the next five years, involving a series of low capital intensity, fast payback, high return on captial projects. These investments are expected to start coming online in 2020.

Taken on the whole, Dow's program of near-term and long-term growth projects further enhances our strategic pillars of integration strength and innovation capabilities, deployed into a focused set of core end-markets.

On that note, I would like to discuss the future of the Materials Science company and the value creation from our unique "integration plus innovation" strategy, on slide 20.

Let's start with the depth and breadth of our integration across the value chain, which continues to serve as a key differentiator and competitive advantage for Dow.

Market dynamics can shift significantly over time, and the last several years bear witness to that. Dow's strategic choice to own entire value chains gives us a competitive advantage to manage volatility through unmatched feedstock flexibility, geographic diversification and a differentiated product and market portfolio. As I have said before, no one rivals Dow in these capabilities.

In contrast to commodity chemical companies that typically run a "cracker plus one" model, Dow is a "cracker plus 5" downstream, value-add player. In fact, in some cases we reach as high as "cracker plus 9," as is the case for our Texas Operations in Freeport.

The power of our key building-blocks of ethylene, propylene and silicones is amplified by our market-back approach, and by leveraging the complexity of molecular and physical integration. This, coupled with our deep materials science expertise makes us the preferred partner to our customers by delivering high-tech solutions from these industry leading technology platforms.

The result of this industry-leading physical integration is a more agile and robust enterprise, ready to adapt at the speed of business today.

On slide 21, while product and asset integration are important foundational elements, there are other aspects of integration that are equally critical in enabling Dow's competitive advantage.

Dow's integrated ecosystem leverages functional and business collaboration in critical areas including purchasing and procurement, leveraged services, information technology, operations and engineering, and it unlocks immense value.

We believe our level of integration is unique, and therefore holds tremendous value. We have done an enormous amount of work over the last decade, both within Dow as well as with independent third parties including banks and consultants, to quantify the value of Dow's integration.

These multiple comprehensive analyses, some of which have been completed very recently, have shown the intrinsic value of our integration approaching $1.7 to $1.9 billion per year.

This is the power of scale and leverage and something we continuously refine. It provides a formidable source of stable and sustainable competitive advantage, and is a benefit that Dow enjoys as a result of our business model, as well as a source of value to our shareholders.

That brings me to innovation, which is at the heart of everything we do at Dow, on slide 22.

As we have pivoted our business to a consumer-led model, we have reinvigorated our innovation engine and enhanced the value customers enjoy from our materials science expertise – earning us a seat at the design tables in our core markets around the world.

This did not happen overnight. It was methodically built through disciplined investments – more than $8 billion dollars in R&D investment over the past five years – coupled with a sharp focus on developing proprietary capabilities to innovate faster and partner more closely throughout the value chain.

We also established core technology platforms that stretch across the enterprise. You can see how we leverage these platforms across multiple businesses and in some unexpected places – elastic adhesives in Dow Automotive; polyurethanes chemistry in Dow Electronic Materials; and cellulosics and acrylic technologies in Dow Building and Construction.

We received a huge boost last year with the silicones addition, which brought an additional platform to unlock new-to-the-world solutions in high-growth end-markets; combining silicones with acrylates, urethanes, polyolefins and cellulosics chains. These chemistry innovations are fueled by our proprietary high throughput research engine and our application development capabilities.

Turning to slide 23, you can see that the results of our efforts are evident. From 2010 to 2016, our innovation revenue has nearly doubled, while at the same time, innovation EBITDA has tripled. And year-to-date our new innovation EBITDA is now more than 1/3 of Dow's total EBITDA.

In summary, market-driven innovation derived from interconnected technology platforms is in Dow's DNA. It is not something siloed in individual business units, but rather these strong technology platform developments are leveraged across the entire enterprise.

We strongly believe that this unique innovation model delivers greater value than any individual business could on its own – and our track record of success speaks to this achievement.

With that, I will now turn the call back to Andrew.

A. Liveris

Thanks, Jim and turning to slide 25.

I'd like to take a moment now to look back on the track record of execution Dow has delivered these last many years.

It's a track record of consistent and reliable financial and operating performance that no other company in our industry can match. In fact, as mentioned, only two other companies in the entire Fortune 100 can.

It's a track record achieved through the foresight and resolve of a highly dedicated Board and management team, who put in place more than a decade ago the strategy you heard Howard and Jim speak to today.

We have thoughtfully and consistently executed against this strategy through a business model that emphasizes long-term value creation, and in doing so have delivered impressive EPS growth, significant volume gains, greater quality and consistency in our earnings, and ultimately increasingly rewarded our shareholders.

We have achieved this through aggressive portfolio management, divesting low ROC, non-strategic assets totaling more than $15 billion of revenue since 2009. We have shifted our earnings mix to more consumer-driven exposure, from 35 percent in the early 2000s to now more than 60 percent of our portfolio.

This has significantly enhanced our ability to generate consistent earnings growth across the cycle. Our beta as a company has significantly reduced as a result – today it is about half of what it was five years ago.

On slide 27, we have highlighted some of our successes in the past, and they bear repeating. An EBITDA growth CAGR of 8 percent over the last four years, with more than $10.5 billion delivered over the past four quarters. An EPS growth CAGR of 18 percent over the last four years, and with tangible drivers in place to push this higher in the near-term. A market cap that we have more than doubled. And nearly $18 billion returned to shareholders since 2012, through share buybacks and a record-high annual dividend.

These numbers have not come by accident. Dow's ability to integrate silicones and achieve greater than $650 million in synergies, plus our embedded integration value of $1.7 to $1.9 billion is a differentiator compared to our peers.

These results have earned us the right to be where we are today, at a turning point in our history.

With that, let's look forward to the upcoming close of our merger with DuPont, as we stand on the cusp of this seminal transaction and the next chapter in Dow's growth story.

All remedy actions are on track. We still have a few more select approvals from key jurisdictions, which we believe are imminent. And we still expect to close in August.

Going into merger close, the Dow team is coming from a position of incredible strength, with a proven track record of success. We are ready for Day 1. Our teams will immediately mobilize to capture the $3 billion of cost synergies. Our playbooks are ready, with clear line-of-sight to milestones and accountability.

We will also move quickly on the intended spins, which we still expect to complete within 18 months of close, with the intended Materials Science Company expected to spin first. Our team remains focused and disciplined, with a sharp execution mindset on continuing to control what we can control.

We have the right strategy, the right long-term growth drivers and the right portfolio. And we have proven it, over and over again. We have never been better positioned to continue delivering for our customers, employees, communities and our owners. We enter the merger strong, and will exit the merger stronger.

With that Neal, let's turn to Q&A.

N. Sheorey

Thank you, Andrew.

Now we will move on to your questions. I ask that you please keep to one question so that we can allow as many people as possible the opportunity to ask a question.

First, however, I would like to remind you that my comments regarding forward-looking statements and non-GAAP financial measures apply to both our prepared remarks and the following Q&A.

Rachelle, would you please explain the Q&A procedure?

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Andrew – before we close the call, would you like to make any final comments?

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Thank you everyone for your questions. As always, we appreciate your interest in The Dow Chemical Company.

For your reference, a copy of our prepared comments will be posted on Dow's website later today.

This concludes our call for today. We look forward to speaking with you again soon.