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EMN.N - Q3 2022 Eastman Chemical Co Earnings Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Third Quarter 2022 Eastman Chemical Conference Call. Today's conference is being recorded. This call is being broadcast live on the Eastman website, www.eastman.com.

We will now turn the call over to Mr. Greg Riddle of Eastman Chemical Company, Investor Relations. Please go ahead, sir.

Gregory A. Riddle - *Eastman Chemical Company - VP of IR & Communications*

Thank you, Maxine, and good morning, everyone, and thanks for joining us. On the call with me today are Mark Costa, Board Chair and CEO; Willie McLain, Senior Vice President and CFO; and Jake LaRoe, Manager, Investor Relations.

Yesterday after market closed, we posted our third quarter 2022 financial results news release and SEC 8-K filing, our slides and the related prepared remarks in the Investors section of our website on www.eastman.com.

Before we begin, I'll cover two items. First, during this presentation, you will hear certain forward-looking statements concerning our plans and expectations. Actual events or results could differ materially. Certain factors related to future expectations are or will be detailed in our third quarter 2022 financial results news release, during this call, in the preceding slides and prepared remarks and in our filings with the Securities and Exchange Commission, including the Form 10-K filed for full year 2021 and the Form 10-Q to be filed for third quarter 2022.

Second, earnings referenced in this presentation exclude certain noncore and unusual items. Reconciliations to the most directly comparable GAAP financial measures and other associated disclosures, including a description of the excluded and adjusted items, are available in the third quarter 2022 financial results news release.

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As we posted the slides and accompanying prepared remarks on our website last night, we'll now go straight into Q&A. Maxine, please let's start with our first question.

QUESTIONS AND ANSWERS

Operator

Your first question today comes from Vincent Andrews from Morgan Stanley.

Vincent Stephen Andrews - *Morgan Stanley, Research Division - MD*

Congratulations on the announcement with Pepsi. Very exciting news. Maybe you could just talk about the balance of the customers at the facility. I don't know if you can name any of the other ones or just sort of tell us how many they are and are they contracted similarly at this point? Or what's left to do there?

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

So Vincent, great to hear from you, and we're really incredibly excited about the Pepsi contract and their commitment. And it is a significant volume for that plant as the baseload for the plant. We have very active conversations going on with several other customers, but we're not in a position at this point to sort of talk about those discussions.

But we do believe the Pepsi agreement, consistent with what we're attempting to achieve with the PET market, is a great endorsement and proof point about the value proposition that we can bring to solving the plastic waste crisis and create economic value for our shareholders at the same time. So we're excited about working with them going forward.

Vincent Stephen Andrews - *Morgan Stanley, Research Division - MD*

If I could just ask a question, get your point of view on all the destocking that's going on. I know from the prepared comments, there's some thought that hopefully will end by the end of the year. But what exactly are you hearing from customers in that regard? And how do you think we'll know that it's over other than it just being over? Like what signposts are you looking for?

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

So it's a great question. And it's one that, as you know and everyone knows, it's a little difficult to call in the moment on what's going on in demand relative to destocking. And I think you got to take it market by market. So the place where we have the greatest headwind is in retail discretionary spend around the planet, especially in Europe and the U.S.

What you had happened, I think, and it's been well documented is, we all knew there was going to be a shift from people moving back to more services, probably leisure from sort of just buying consumer goods in the COVID situation. But I don't think anyone really understood the significance of that, combined with extreme inflation on how much the pivot could turn into being. So people stay committed to travel, as we all know, from the airlines. But with this extreme inflation, affordability for everything else in our life was very constrained. And so they've really cut back on anything that's a discretionary spend.

And then you had all these ships loaded with all kinds of consumer goods caught on the ocean, caught in ports, and it all showed up in the second quarter, and you saw Walmart, Target, Best Buy, et cetera, have a huge problem on retail inventory to sales that continues to now. Unfortunately, the wholesale chain supplying it doesn't have that much of an inventory, but you still have a huge amount of destocking occurring at the retail

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level. And you can see that flowing through and impacting some of our customers like Whirlpool or Electrolux and the announcements that they have out there.

So you get a pretty significant decline that's both the demand and a significant destocking event that's occurring as we are in the fourth quarter. And I'd say that's the one part of the market. It's a little hard to call to say when that sort of combined destocking demand situation plays itself out.

When you look at the broader set of what's going on, there are other factors impacting the market. So you've got Europe in stagflation, where high energy costs and high inflation is driving a drop in consumer demand, but energy costs are staying high. You've got China with a no-COVID policy constraining consumer behavior and a B&C industry that's been in trouble for over a year. And the U.S., building construction market is not doing well either as you can see in all the housing data that's been coming out recently, even in the third quarter GDP number. So that impacts a lot of demand across our portfolio.

The B&C is not off as much, especially in North America. It's quite sort of -- there's a lot of momentum in that market of houses still being completed and painted and appliances being brought forward, but you can see that coming off as you go into next year. And then you even have even stable markets that -- like a P&G and other markets out there who are doing well, but they're still looking at their inventory and going to destock high-cost inventory to generate cash for the end of the year and position themselves for lower prices in the future.

So you've got modest destocking going on in stable markets that I think will play itself out by the end of the year. You've got Europe and China, which has been challenged for a while, so that destocking, I think, is largely playing itself out by the end of the year. The U.S. has more in the earlier phase of that destocking and change for what's going on in the marketplace. So those are sort of the way we see it around the world.

And then you've got positives, right? So the automotive trends are good. You've got recovery that we're already seeing as a benefit in the third quarter and sequential improvements into the fourth quarter. You've got the EV trends where we make an exceptionally large amount of money relative to an ICE car, 2.5, 3x as much value. So as those are becoming more part of the mix, that gives us another mix upgrade. And you've got consumers that are still in a financial -- consumers in a financial system are still relatively healthy that sort of balances out some of these trends.

So we think that a good amount, greater than 50% of destocking, plays itself out through the end of the fourth quarter. And so that means as you look at next year, with the destocking being more behind us and returning to sort of what we're thinking about as mild recession terms, demand improves in a meaningful way as you get past the fourth quarter from a primary market demand point of view. And then on top of that, as we look at next year, if we get innovation happening across our marketplace, that's going to drive a lot of growth. And you've got the lack of the outages that we had this year that hit us by about $100 million of missed volume mix that put us well below market demand this year. So there's a lot of upside in that available capacity and a lower planned shutdown schedule in a meaningful way next year that gives us more volume to sell.

So there's a lot of reasons that as we get through this quarter, some of this destocking behind us, that volume next year will be better, even in a mild recession.

Operator

Our next question comes from David Begleiter from Deutsche Bank.

David L. Begleiter - *Deutsche Bank AG, Research Division - MD and Senior Research Analyst*

Mark, on the $150 million of cost you've targeted for next year, how much is structural and how much is somewhat temporary? Does that include the lower shutdown costs or turnaround costs next year versus this year?

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William Thomas McLain - *Eastman Chemical Company - CFO & Senior VP*

David, thanks for the question. This is Willie. As we think about the $150 million, I would look at it in two buckets. Roughly $100 million, we expect to be on the manufacturing front. And obviously, as we've talked about inflation being a key factor, as you think about the demand that we had in the first half of 2022, along with the outages, that's driven a lot of inefficiency. And we expect that to be a large component as you think about contractors, as you think about the level over time. So I do view that as structural as we get back to operating in a, call it, a more controlled demand environment that we'll be taking a significant amount of that type of cost out of our system.

There will be, I'll call it, a lower amount of planned turnarounds. That will be, I'll call it, a smaller portion of that $100 million that we see in the manufacturing space. As it comes to the nonmanufacturing, that's about 1/3 of the actions that we see. And in many cases, what I would say is the level of consulting spend discretionary, so that's more of, I would say, variable versus structural in the current environment as we expect to continue to invest in the growth programs, as was just highlighted. With the third project gaining momentum with our circular investments, we will balance that out of $150 million structural/discretionary to ensure that we can continue those investments.

David L. Begleiter - *Deutsche Bank AG, Research Division - MD and Senior Research Analyst*

Very good. And Mark, just Slide 12, looking at initial '23 guidance perhaps. It looks like you're looking at perhaps a modest, maybe 5%-type EPS growth year-over-year. Is that in that ballpark?

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

Well, good question, Dave. We're not going to be giving quantitative guidance about 2023 versus this year, which we still have to finish out. But what I would say is we look at the tailwinds and the headwinds, in a mild recessionary environment, we think we're in a good position.

It's obviously a very dynamic time right now, whether it's what's going to happen in China, the Ukraine war or inflation, et cetera. There's a lot of uncertainty, and that certainly goes back to a trade war in '19 and a pandemic in 2020. What we know is the market is challenged, as I just said, around the short term in the recessionary environment that the manufacturing world seems to be entering. And I do think a lot of the destocking will play itself out.

So we're really focused on what we can control. And I think the volume and growth side of things is in a good position with over $400 million of new business revenue closes on innovation. We've got a lot of tailwinds, whether it's the multifunctional layers growing and EVs, the tremendous success we're having in our paint protection films, growth we're seeing in Tetrashield and food and beverage cans. Really seeing a lot of growth continuing even in the semiconductor environment for our high-purity solvents as we expand the product portfolio there in sustainable coating items, et cetera. So a lot of innovative growth going.

And I do think there's a meaningful tailwind that comes out of the lack of unplanned outages that we had this year next year, and then less planned outages obviously helps as well. So that's one component.

An equally important component is spread improvement, right? So when you think about what we've been through in the last 2 years, right, you had about $1.3 billion of inflation in 2021, and we had pricing in place that caught most of it, but we still had some spread compression in the specialties in the back half of '21. So when we started this year, we had a view that we're going to have $500 million of inflation this year. We have pricing in place to deliver a much greater than $100 million of spread improvement in the specialties. We didn't plan on having another $900 million of inflation through the rest of the year, so a total of $1.4 billion. When you sort of take our view of the fourth quarter here, it's a significant headwind.

And the teams have done a phenomenally good job of keeping pricing going with the strength of our value propositions and the specialties to keep pace with all of that inflation. And of course, Chemical Intermediates has done well in the first half of the year. But while we kept pace, we didn't recover the spreads that we were aiming to get from what we sort of gave up in the back half of '21. So there's that opportunity that's still in front of us. And with inflation being as high as it is now, that opportunity is much greater in how raw material and distribution costs could fall

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and what the spread tailwind will be next year as we're going to continue to have very strong discipline in pricing, because we are committed to getting our margins back to 2019 levels before all this inflation chaos started. So I think that's a pretty significant upside.

I think an equally significant upside is a real change in the Fibers business. As we've told you, we faced a lot of inflation and increasing operating costs in the Fibers business in '21 and '22, and that's pushed our margins down pretty significantly. And there was a recognition with our customers already this year that those costs needed to be recovered for us to be a reliable and sustainable supplier to them. And you've already seen us have a lot of price increases this year, but it's only covered a portion of that inflation as far as the recovery goes. And we've already succeeded in locking in contracts with a significant portion of our customers with prices that will allow us to significantly improve our earnings relative to this year. In fact, so much so, that we believe it would offset what we've said in our prepared remarks about the normalization of Chemical Intermediates.

So that's a significant improvement in earnings, taking us back many years into where that business will sit and be much more sustainable, more profitable, more cash-driven business. And then as we just discussed, we got $150 million of cost reductions. So a lot of tailwinds that offset those headwinds that we have with pension costs and growth spend and currency so -- and interest expense. So net-net, I think in a mild recession, will be greater than this year, but I'm not about to quantify how much.

Operator

Our next question comes from Jeff Zekauskas from JPMorgan Chase.

Jeffrey John Zekauskas - *JPMorgan Chase & Co, Research Division - Senior Analyst*

What's the financial terms of your agreement with Pepsi? How do you price the material to them? Or how do they buy it from you?

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

Thanks, Jeff. So we're very excited about this commitment with Pepsi. And we don't discuss the specific contract terms with any of our customers. And in this case, in particular, we view our contracting approach for the circular economy as a competitive advantage.

What I can tell you is the contract did align with our circular contracting strategy that we've discussed with investors in the past. These agreements really demonstrate that molecular recycling is an essential part of solving the plastic waste crisis in sort of collaboration with mechanical recycling industry. And we really view this Pepsi commitment, which is one of the most significant and most successful brands in the world, that they see the value in what we're doing, both from an environmental point of view, and it also demonstrates that we have an economically viable platform when we meet these terms in this contract strategy.

So when you think about the principles that are behind this contract strategy for these types of contracts, we will have margin stability in how the product is sold to them and it's structured relative to what goes on in the marketplace. And these contracts will be long term and have a -- in this case, a sufficient base load for us to commit to this third plant. So we can see a clear vision of the cash flow necessary to provide appropriate return on investment on this.

So it's a really exciting situation we find ourselves in. And I would say that back to Vince's question, there's a lot of companies out there who are excited. We have over 1,000 SSOs already for our first plant. We're going to be starting up in the spring of next year on a wide range of specialty products. The brand engagement in Europe is incredibly strong, both in specialty as well as in PET.

And I think it's really a significant proof point when we get this contract, that there has to be a pathway for hard-to-recycle materials back to food grade to sort of truly have a circular economy in that marketplace, that we can partner with mechanical recyclers. It's an essential part of solving this problem, that we're going to do this at a lower carbon footprint and make sure that we have a very minimal impact on the communities that we operate in.

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And importantly, we need to make sure we don't move to other materials. Plastic is by far the most carbon-efficient product out there for these applications. And if we don't use plastic, then we're going to have a huge impact negatively on climate if we start moving to glass, aluminum as well as other products. And frankly, in many applications, there just isn't an alternative material that's going to work for the brands. So for us, we think this is a big part of the circular economy, and we feel great about working with Pepsi as an anchor client.

Jeffrey John Zekauskas - *JPMorgan Chase & Co, Research Division - Senior Analyst*

Okay. And then for my follow-up, in Chemical Intermediates, are you closing one of your smaller crackers permanently? Or what are you doing with your closure? And can you discuss what's going on with propylene spreads in that it doesn't look like people can make money taking propane to propylene at this particular point in time? How is the propane/propylene dynamic affected Eastman during the year relative to last year or now relative to previous quarters?

William Thomas McLain - *Eastman Chemical Company - CFO & Senior VP*

Okay. Jeff, this is Willie. I'll answer the first part of the question as we think about our operations. So as we've highlighted earlier, given the -- one, the amount of inflation that we've seen this year in working capital and through raw materials, we're looking at that in concert with the demand that we see, and we've highlighted the destocking that we expect -- have seen in late Q3 and we're seeing here in Q4. So as we're in a planned turnaround for one of our crackers at our Longview, Texas site, we're taking that opportunity to keep it down the remainder of the year to ensure that in our olefin stream, that we bring our inventories back in line and that we also move through some of the higher cost, both from an energy and raw material front and get that through this year so that we're better positioned in 2023 from both an operation and supply chain and working capital standpoint.

As we think about propylene and propylene margins, what I would highlight is, again, we continue to optimize our operations. We've made the investment in the refinery-grade propylene. That is continuing to play off quite well as we see the current economic environment. And also, again, our propylene derivatives have continued to perform strongly in the first half. And while those margins are normalizing some in the second half, as we had expected, this is still a very strong part of Chemical Intermediates and is delivering the cash for the company.

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

Yes. I'd also add, Jeff, that our teams on the commercial side are doing just an excellent job of pricing discipline. So we don't sell propylene, right? We sell derivatives. And those prices, we were able to hold those prices flat to Q2 sequentially through the third quarter. There will certainly be prices coming off, and some of these customer contracts or cost pass-through contracts who are tied to propylene that -- so you'll see prices starting to come down in the fourth quarter. But our view is pricing discipline in times of sort of economic transition like this is incredibly important versus chasing demand that's frankly not there because they're destocking anyway.

So from an earnings and cash point of view, we're managing a trade-off between volume and price in a market where we're waiting to see where primary demand really settles and holding on to value as long as we can.

Operator

Our next question comes from Duffy Fischer from Goldman Sachs.

Patrick Duffy Fischer - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Yes. First question, Mark, when you look at what your expected sales are for the fourth quarter and look at what your planned operating rates are, did you bring operating rates down enough that you don't think you'll build inventory? Or what will you do with your inventory throughout fourth quarter if the numbers hit the budget you have planned?

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William Thomas McLain - *Eastman Chemical Company - CFO & Senior VP*

Duffy, we are expecting -- this is Willie, we're expecting a decline in sequential revenue and volume numbers. We're adjusting our operating rates not only for that, but we're looking to take our inventory quantities down somewhere between 5% and 10% on top of that. Obviously, we've highlighted the steps that we're taking within our olefin streams, but we're managing that across the enterprise and the portfolio. The utilization rates and the impact on our P&L from that is baked into our guidance.

At this point, what I would also highlight is what we see here in October from an order and demand pattern is basically in line with our expectation as we've outlined.

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

Yes. We made a decision that cash is an incredibly important part of any company and certainly in our value proposition. And it's obviously very challenging here when it comes to cash with working capital and all the inflation that we're trying to manage. But we are focused on generating cash in the fourth quarter and taking the actions necessary to do that as our priority and positions us well for next year in how we sort of drive forward and run our plants next year well; as well as position for lower-cost raw material that we're going to be purchasing; that we believe we already see the trends now in the marketplace of raw materials coming off, that we'll see already flowing through in the first quarter and how to position ourselves even better for that in January.

Patrick Duffy Fischer - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

Okay. And then the issues you've had with shipping out of the East Coast, the port issues, what's the resolution to that? Have you found kind of alternate routes but maybe more expensive ones doing trucking or rail to get to other ports? As we get into the first half of next year, is that something that's going to continue to be a headwind for you guys? Or do you have solutions outside of -- again, hopefully, the ports themselves just getting better over time?

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

First of all, the ports themselves are getting better. And with the reduction in demand in the U.S. as well as in other economies, the amount of trade occurring on a lot of what we were shipping in containers out of those ports has lowered itself. So the logistic constraints are not a major factor in the fourth quarter, and we don't expect it next year. In fact, we expect to see a significant distribution cost tailwind for us next year relative to this year for two reasons.

One, with demand as tight as it was and all the challenges we had in keeping customers supplied, we use a lot of different expensive modes of transportation to make sure we honored our commitments to our customers. And so those modes were a higher cost to us, some of which we passed on in pricing, but some of which is something we're not going to use next year and pick up a cheaper position in how we transport products from a mode point of view. And then, of course, distribution rates are coming down. You can see it on major routes like the dramatic drop in container costs between China and here.

So we really do think this goes from a significant logistics constraint on volume limitations this year that we couldn't serve, even though demand was there and very high modes and rates to a meaningful tailwind next year as we optimize our operations and our distribution to a sort of softer environment.

Operator

Our next question comes from Frank Mitsch from Fermium Research.

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Frank Joseph Mitsch - *Fermium Research, LLC - President*

One of the more surprising thing, I want to come back to the Fibers contracts for 2023 because that seems impressive that you're able to drive that much profit growth already signed up for next year. And also in the prepared remarks, it said that it's going to bring the levels back to sustainable investment levels. Are you indicating that perhaps we might see capacity expansions in this business? And any other color you could give us in terms of why we're seeing such a step change for 2023 would be helpful.

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

Yes. So to be clear, we're not intending to add tow capacity. So let's just make sure we're clear about that. When we talked about getting sustainable margin levels, it's to be a reliable supplier. When you look at the situation, we had a view of the market declining 2% to 3% in tow year-over-year, and it's now changed to being sort of flat to down 1%, partly because the overall market just isn't declining as much as people thought and equally important, the heat-not-burn market is growing phenomenally fast. So companies like Philip Morris and the other brands had these very successful heat-not-burn products, and they still use quite a bit of tow.

And so thinking it hadn't included how that would offset the tow decline in sort of the traditional products. So when you put it all together, you've got a much more stable end market situation than I think what people expected.

Second, and this is unique to Eastman is textile growth has been fantastic, and we continue to see strong interest in our product. When you think about a product that's made from half certified -- sustainably certified forest wood pulp and the other half now being recycled plastic, it's just to create value proposition on beginning of life. And in the life concerns about microfibers from textiles ending up in the ocean are certified to biodegrade, that's a very strong value proposition for the marketplace, and we're seeing just great brand engagement on that. So you've got growth in that, that's more than offsetting the decline in tow that we see. So our assets are tight.

And then you combine those two facts with less supply being available because what we have done actually is repurposed some of our tow assets to making textiles, right? So that took some capacity out of the marketplace. Other companies have optimized their capacity, whether it's in Mexico or now because of the Ukraine war in Russia, you've got less supply than existed several years ago. So in that conversation, our customers really want to make sure we're going to be a very highly reliable supplier to them to meet their needs. And for that to be the case, we need margins at a better level than where they're at right now. So we're able to get price increases this year and add on pretty meaningful price increases next year to get us back to more appropriate margins for this business. And so it's...

Frank Joseph Mitsch - *Fermium Research, LLC - President*

Well, they say there's no business like tow business.

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

Yes. So just one thing I wanted to mention is that the contracts also include provisions to adjust for changes in variable cost, which we didn't have in the past. So that makes them a little bit more predictable too, on how they're going to perform.

Frank Joseph Mitsch - *Fermium Research, LLC - President*

Got you. Got you. And I also wanted to ask about, in this environment, it's very helpful to have an asset footprint that skews more towards the U.S. than Europe. But you still have a lot of assets over in that part of the world. We're starting to see some other companies talk about rationalizing capacity in that part of the world. And I'm wondering what your thoughts are on the long-term viability of your assets over in Europe.

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Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

So first, when it comes to Eastman, about 75% of our production from a volume point of view is in the United States, right? So that's a significant competitive advantage for us on an energy cost basis relative to other markets. And you have to remember that 55% of revenue is outside the U.S. And most of what we sell in Europe and China, in particular, are our specialties. So we, in how we serve our global markets, are in a very strong cost position. Obviously, currency is not helping at the moment. But long term, I think that energy position is going to be a strong competitive advantage.

When it comes to Europe, our asset base in Europe is a lot smaller than it used to be after we sold the tires and adhesives business, which has significant assets and energy-intensive assets in Europe. So with what's left now, we have our interlayers plants and a small performance films plant, which are more electricity driven and not that energy intensive. Our most energy-intensive asset is our amines facility in Belgium. So the segment that's most impacted by us is AFP when it comes to high energy costs, where for that segment, about 35% of their production as is based in Europe.

And so they're seeing a pretty significant energy headwind. If you just look at the fourth quarter, it's probably a $20 million headwind that they're facing on a year-over-year basis relative to sort of where they were a year ago for just that segment. But none of these assets are in a position where we were concerned about them being economically shut in because the costs are so high. And we feel we have a very good plan in place, especially in Belgium, to feel that we'll get the natural gas supply that we need through the winter.

So on top of it, a lot of teams working to make sure everything has got supply agreements in place, so we don't get rationed and we don't have a concern around the economic impact from a viability of the assets.

Operator

Our next question comes from Matthew DeYoe from Bank of America.

Matthew Porter DeYoe - *BofA Securities, Research Division - VP*

So I believe this morning, you have some euro-denominated debt maturities approaching. Does it make sense to take that out with USD debt? And how are you thinking about the term loan? I guess as well, what are the implications for next year's interest expense with all this? And does this kind of shift your commitment to the buyback?

William Thomas McLain - *Eastman Chemical Company - CFO & Senior VP*

Okay. What I would highlight is, to your point, we've got a roughly EUR 700 million -- EUR 750 million coming due in May of next year. I would say, the treasury team is proactively looking at how we will manage that. You can expect us to probably put some things in place here in Q4 and finish things off in early Q1. As we've seen rates move compared to that, it's probably, call it, roughly a $25 million to $30 million headwind on a year-over-year basis based on the rates that we see now.

As we think about the share buyback, we're still committed to the $1 billion that we outlined for this year. And also, as we think about cash flow and strategic cash available as we look into 2023 with what Mark outlined, I see operating cash flow in a normalized working capital environment and also with the ability to increase our cash earnings of potentially being $300 million to $400 million higher on an operating cash flow basis. So absent with that less our dividend, that puts us at $1 billion plus of strategic cash for our organic growth strategy as well as bolt-on and share repurchases in 2023. And you got to believe in 2024 that we're back to that $1.6 billion or above operating cash flow.

Matthew Porter DeYoe - *BofA Securities, Research Division - VP*

I guess following the agreement with Interzero, what percent of your France facility is now feedstock locked in or contracted or secured?

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Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

We've said the Interzero contract worth about 20,000 tons, and we're building in two phases, 150,000-ton plant. So it's a good step, but it's not a huge percent of the plant. I would say we have other agreements under discussion right now that would get us close to what we need for start-up and feel very good about that and the progress we're making. It's pretty remarkable when you think about that we're locking in contracts for when these plants start out in the '25, '26 time frame and getting these commitments.

And most importantly, what I'm most excited about is the fact that these conversations with these mechanical recyclers are coming to a viewpoint that we need to collaborate together. Mechanical recycling is vital to solve the plastic waste crisis. They have a low energy footprint. And where they can take waste back mechanically into applications is great, and that's what should happen.

Unfortunately, there's a huge amount of packaging waste out there as well as textile and carpet waste that cannot be easily mechanically recycled, especially when I'm talking about going back to food grade. There's real limitations on what you can do in mechanical recycling back to food grade. And so we become an essential partnership to really create a circular economy in that sort of high-value packaging market, and they see that. Also, there's a long-term viability question with mechanical recycling because the polymer degrades over time and really has some sort of performance quality issues after several heat cycles. And we can take that degraded polymer and bring it back to life through our facility.

And so it's a partnership that really allows mechanical recycling companies to have a long-term future, allows plastic to have an infinite life in how it can be recycled at a little much lower carbon footprint than the current process. So they see -- Interzero sees that, a couple of other announcements you'll hopefully see before the end of the year is an acknowledgment that the system requires collaboration to really bring -- and keep the most carbon-efficient material in use in a way that doesn't impact the environment.

Operator

Our next question comes from Aleksey Yefremov from KeyBanc Capital Markets.

Aleksey V. Yefremov - *KeyBanc Capital Markets Inc., Research Division - Research Analyst*

Could you discuss what share of the third methanolysis facility is covered by the Pepsi agreement? Is this enough for you to make FID? And if so, when are you planning to break ground?

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

So we're not going to disclose the volume. As I said before, we don't discuss sort of specific contract terms with our customers. In this case, what I can tell you is this commitment was the key milestone we needed to achieve to feel we could have confidence in the economics to move forward in starting the engineering work and in the planning to construct this plant in the U.S. So both the contract terms, the length of the contract and the size of the contract give us confidence to start aggressively moving forward in the construction of this third plant. So that's where we needed to be, and we're excited about this partnership.

And I would also note that there's a lot of other customers who are very interested in this capacity. So we'll be accelerating those conversations now that we've got the sort of base load position set to get you some additional customer announcements.

Aleksey V. Yefremov - *KeyBanc Capital Markets Inc., Research Division - Research Analyst*

Thanks, Mark. And staying with recycling, it looks like virgin plastics prices are falling in many cases and so as the feedstock for mechanical recycling. Does that change your discussions with potential suppliers of feedstock and also with potential customers for your recycled materials in any way, basically the current market conditions?

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Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

Yes. I don't think it's changing anything significantly. There's obviously going to be ebbs and flows with supply and demand in the packaging industry, which compared to consumer durables is a far more steady industry. So what I also like about the circular platform is it improves our revenue coming from much more stable end markets from a demand point of view, which is a nice upgrade to our portfolio.

But when it comes to sort of the trends in prices, especially in the economic chaos we've had of extreme inflation and then now companies hoping for cheaper prices in the future, you're going to see a lot of short-term volatility that we don't see any of our customers getting distracted by it because they're looking at how do they hit commitments in 2025 and 2030, right? That's what all these discussions are about. It's not about what is my composition of virgin versus rPET in 2022, right? That's just not how they think about it. They think about how I build a roadway to 2025 hitting those commitments.

But in the short term, if I need to save a little money, I'm going to make trade-offs on what I'm buying today, but they're not -- they can't back off of their commitments. And in Europe, it's not a choice for the brands, right? It's a mandate in government legislation. So in Europe, if you don't hit your recycling targets, you're starting to pay some pretty significant taxes, and that's a real bad look for brands of not solving the recycling content and solving it by paying a tax coming up short in their targets.

So in Europe, you've got very sort of structural reasons that they have to stay committed to how they're going to solve this problem. Mechanical recycling infrastructure is not remotely capable of providing enough recycled material to the packaging industries. That's where our value proposition shows up.

Operator

The next question comes from P.J. Juvekar from Citi.

Prashant N. Juvekar - *Citigroup Inc., Research Division - Global Head of Chemicals & Agriculture Research and MD*

Mark, I have a question -- another question on inventories as it relates to cash flows. Your cash flow from operation is down more than 50%. You pointed out the hit from working capital being $500 million hit. So I guess my question is, how much of that is from your actual cost going up for raw materials? And how much of this is from level of inventories going up? And when -- can you describe where inventories got to in terms of days and where do you think that will go? So that's my first question.

William Thomas McLain - *Eastman Chemical Company - CFO & Senior VP*

Thanks, P.J., for the question. What I would highlight as we went into the second half of the year, we had some large turnarounds as we've highlighted here in both Q3 and Q4. So we were building inventories going into the second half. I would highlight at that point, there was probably roughly half of raw material, energy inflation and half quantity. We brought those quantities back down through Q3. And we'll be expecting that by year-end, effectively, the entire increase is raw material and energy inflation. So bringing our DQO, DIO numbers back in line with the prior year-end.

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

I mean if you think about the first 8 months, we are trying to ship things as fast as we can make it in serving market demand really through most of August. Some of that was outage related and raw material availability-related interlayers that constrained our ability to supply markets. But demand was great. It was just a logistics or a production constraint in getting it all served. But the market has obviously shifted pretty dramatically in September and through this quarter in destocking.

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Prashant N. Juvekar - *Citigroup Inc., Research Division - Global Head of Chemicals & Agriculture Research and MD*

And I appreciate your discussion of a mild recession in your prepared comments. You mentioned amines, acetic anhydride and plasticizers to kind of hold up even if olefins decline. Amines and plasticizers have been cyclical in the past. So why do you think they'll hold up in a mild recession here?

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

Yes, sure. So one of the things that's been an important evolution of our portfolio in CI is the growth in functional amines. When you look at that business tied to ag, which is obviously having a good year this year and expect to have a good year next year, and so we are tied to ag demand, but has phenomenally attractive and very stable margins because most -- almost all of that business is in cost pass-through contracts. So that business didn't have market tightness driving spreads up in the last 2 years, and it's not going to have market looseness driving spreads down because they're CPTs. So that's just a great business and really quite attractive, just like the care chemical business and AFP.

When it comes to acetyls, you've got a business. Acetic anhydride relative to other acetyls is actually very stable in its margin. So again, it didn't have a fly-up in margins in '21, '22, and it's not going to have a big decrease in margins when the market soften. It's just the nature of those end markets like pharma and food applications are more stable in what happens with them on a margin basis. But margins will certainly come off a bit there, but they will be more than offset by much higher volume.

We had significant restraints on volume this year at acetyl production because we had some significant planned shutdowns. And then the outage has impacted their production run rates as well. So without the planned shutdowns and sort of better operations, we have a significant volume upside that we're confident we can place in the marketplace to sort of have acetyls be relatively stable to this year.

And then specialty plasticizers, which are sort of benzoic derivative products, again, historically very stable and reliable. And when you put those three together, that's 50% of the EBITDA of the segment, right? So general plasticizers in our case, DOTP as well as all the other olefin derivatives is the other half. And when you look at that part, that most volatility usually comes from the bulk ethylene as opposed to the derivatives. And you can go do the math and see that the margins in the bulk ethylene are already incredibly low.

We've, one, reduced it as much as possible, as Willie said, using RGP to sort of minimize ethylene production. But the margins are sort of a cash cost in the back half of the year and weren't great in the second quarter. So looking at next year, that's not a sequential headwind in '23 to '22 in any meaningful way. So it's -- you're now a little down to olefin derivatives pricing coming off.

But when you think about that, half the earnings is in these very good businesses that are very stable. The bulk ethylene headwind is behind us to a large extent. So the amount of decline you can have in the olefin derivatives, even if it's significant, it still allows us to be at that sort of normalized $300 million rate that we talked about. So that's sort of how we sort of look through all that. And so we feel that's actually great performance in a mild economic recession for this business. And in the total portfolio, so it will be offset by fibers, which allows specialties to drive our earnings growth.

Operator

Our next question comes from Laurence Alexander from Jefferies.

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

So I just wanted to flesh out the discussion on pricing and sort of the price initiative-driven spread expansions. Are you seeing any change in the volume elasticity of demand in response to price initiatives, particularly in Europe, where I guess the slowdown has been going on the most?

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Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

Well, I think you have to get clear about what is primary demand in the marketplace, what is destocking and then what may be driven by pricing, whether it's destroying end market demand or losing share to competitors where you have to examine the price question.

We're not seeing any sort of specific destruction in demand because of our pricing at the consumer level. Frankly, when you get to the price of the product on the shelf, our component of almost every customer's cost structure is really quite small. So we're not really a driver of where they go on the pricing on the shelf when it comes to consumers.

When it comes to share loss, we're keeping a very close eye on as our pricing driving any share loss especially around the commodities for that matter, and we're not seeing any of that. Now it's a little hard to see through that when you've got destocking going on. So you never know quite, is it then just pulling inventory down or shifting share? It takes a few quarters to sort of figure all that out.

But what we can see right now based on the end market information we have is our -- what we're seeing in demand drop aligns with what's happening at the market and what the retailers are doing in destocking. So we feel being very disciplined on price, and holding firm on that while we wait for market clarity is the right strategy. And we have very strong value propositions that allowed us to increase prices to cover $1.4 billion of inflation this year. So we're confident we can hold our prices relative to how raw material and distribution costs decline next year to improve our spreads back to more appropriate levels.

So we're feeling good about that. We just need the raw material declines we're already seeing to continue happening into next year and also the same on the distribution costs. You'll notice I'm not saying energy as a tailwind because I think that's a lot less certain on where energy goes. And so we're not assuming a tailwind in energy next year with all the dynamics going on around the world.

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

Okay. And then just the -- a couple of years ago, like one of the debates around the Green Premium was that as you brought up -- aim to bring on larger facilities, that premium would compress. And it doesn't sound like that's happening. Is that right? Or can you characterize how resilient? If anything, is the Green Premium increasing as the CPG companies realize how tight their supply, renewable or recycled product, is going to be?

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

Yes. So first, I don't think we've ever thought the Green Premium was going to compress over time, at least not over the next decade because of the supply and infrastructure needed to solve the plastic waste crisis at a lower carbon footprint. So we're making both climate and waste better. It's just significantly beyond what we and others can add to solve that, right? So simple macroeconomics, demand is going to be a lot greater than supply for quite some time. So the value proposition of recycled content in polymer is a true specialty product for some period of time here in what it uniquely brings to the marketplace.

At some point, is it possible that people add a lot of capacity? Sure. But that's way out in the future for when that starts sort of exceeding demand.

Operator

Our next question comes from Kevin McCarthy from VRP.

Kevin William McCarthy - *Vertical Research Partners, LLC - Partner*

Would you discuss your capital budget profile for this year and next? It looks as though you took $100 million out of the plan for this year. Are there any projects that you're rethinking in this environment? Or is that more of a timing issue whereby it would shift into '23?

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William Thomas McLain - *Eastman Chemical Company - CFO & Senior VP*

Thanks for the question. So as you think about cash flow progression, obviously, we've evaluated our portfolio of capital, and we've taken actions on both fronts. So there's both timing as we've highlighted earlier this year. Some projects were getting pushed out as a result of supply chain issues. Those are resulting in some of those cash flows now falling into 2023.

Additionally, again, we've reduced and focused our portfolio. We're investing to ensure that, one, that the safety and we maintain our plants well; two, that we continue to grow our core specialties; and then three, as we spent time today talking about our circular platform. And I'll use that to bridge in the 2023 expectation. So what I would say is in a mild recession scenario, a range of where we are currently at $600 million or it could be as much as $100 million or $200 million higher as we make progress on all three of our projects.

So as Mark highlighted, the fact that we'll be completing, mechanically complete here at the end of the first quarter of our Kingsport methanolysis facility and as we make progress on both our France project and our third project here that will be in the U.S., that will increase the level of capital. And we're confident in the cash flow that we're going to generate and allocating a significant portion of that strategic cash to our innovation-driven growth model and the circular platform.

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

And the key to winning at times like this is staying focused on how you're going to create value long term and making sure you're positioning yourself for the other side of an economic correction to be the winner. So we're not losing sight of that. We may adjust the timing of some projects relative to when we expect the demand necessary. And frankly, the softening economy will make construction costs cheaper. So it will actually help us out in some of this inflationary element of CapEx costs.

Kevin William McCarthy - *Vertical Research Partners, LLC - Partner*

Okay. That's helpful. And then secondly, for Willie, on Slide 12, you referenced a pension and OPEB headwind of $100 million. What is driving that? And is there any cash attached to it in terms of what you may have to inject? Or is it strictly a P&L issue?

William Thomas McLain - *Eastman Chemical Company - CFO & Senior VP*

So let me first start with our pension plans are well funded. Two, there's no near-term cash requirements that we would expect. Our large U.S. pension plans are still, today, roughly 100%-plus funded. The key factors here are really about the accounting. At the end of the day, discount rates and interest rates have gone up. So we'll have a gain at the end of the year in our mark-to-market. That comes back in as a higher interest cost in 2023. Additionally, with investment performance this year, the asset base has deteriorated. But ultimately, that will result in lower return on asset.

So bottom line is from a cash and from a funding standpoint, there are no issues. I would just attribute this to mark-to-market accounting and the volatility that we're seeing in both interest and assets here in 2022.

Operator

Our final question today comes from John Roberts from Credit Suisse.

John Ezekiel E. Roberts - *Crédit Suisse AG, Research Division - Research Analyst*

Two quick ones here. One is since Interzero is burning the waste plastic you're going to get in Europe, are you going to pay something just over fuel value for that waste?

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And then secondly, in your 2023 guidance, you've got pension costs going up. I don't think I've heard of anyone actually talking about higher pension costs in '23 yet. So maybe you could tell us how that's coming about.

Mark J. Costa - *Eastman Chemical Company - Chairman & CEO*

So Interzero, we're not going to disclose the price we're paying for the material, but it is a very attractive price that supports our economics. And there's a whole spectrum from things that go to waste, things that are going to park benches to some modestly higher down-cycled applications. And so it's a portfolio managing on price to make sure the sort of average comes out. And we're seeing that very much on track with the economics of these platforms delivering $450 million of EBITDA across these three projects when they're all up and running. So feel good about the pricing that we're getting as well as where the feedstock price is set.

Gregory A. Riddle - *Eastman Chemical Company - VP of IR & Communications*

Yes, John, I thought the last question was on the pension. So it has been answered. Go ahead, John. Yes. Okay.

This concludes our call for this morning. Thank you very much for your time and for joining us and your interest in Eastman. Have a great rest of your day.

Operator

This concludes today's call. Thank you for your participation. You may now disconnect.

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