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EDITED TRANSCRIPT

EMN.N - Q4 2022 Eastman Chemical Co Earnings Call

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PRESENTATION

Operator

Good day, everyone, and welcome to the Fourth Quarter and Full Year 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, Emily, and good morning, everyone, and thank you 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 fourth quarter and full year 2022 financial results news release and SEC 8-K filing. Our slides and the related prepared remarks in the Investors section of our website, eastman.com.

Before we begin, I'll cover 2 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 fourth quarter and full year 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-Q filed for third quarter 2022 and the Form 10-K to be filed for full year of 2022.

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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 fourth quarter and full year 2022 financial results news release. As we posted the slides and accompanying prepared remarks on our website last night, we'll go straight into Q&A. Emily, please let's start with our first question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will now go to our first question from Josh Spector of UBS.

Joshua David Spector - *UBS Investment Bank, Research Division - Equity Research Associate - Chemicals*

I guess first one to ask, can you walk through your step-up in your implied guidance from first quarter through the rest of the year? I guess mostly interested to hear how much you see this within your control versus subject to macro conditions changing?

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

Sure, Josh, and welcome. We expected that question. I think it's an extremely important one, which we spent a lot of time on. First, let's just recognize we're in an extremely dynamic time in this world where it is difficult to predict some of the macro. You've got China in a weak situation but likely to recover, in one article saying there's $2.2 trillion of cash out there with Chinese consumers to be deployed and how that impacts both demand and energy. And Ukrainian war, you've got inflation at 4-year highs and what the Fed is going to do with it. So there is a lot of uncertainty and the fourth quarter was a little bit challenging.

As we look at Q1, many of those challenges continue, whether it's the destocking in durables and B&C that still needs to work itself out, although not yet recovering. And the stable market is virtually getting pass destocking, but not growing yet. We will certainly see some raw material benefits in the first quarter, but not much in the way flow-through works and seasonally energy is high. So the first quarter has a number of challenges, not to mention pension and variable comp.

So as we look at the step up into the second quarter and through the rest of the year, there's really 3 key elements. To your point, the one that's most directly in our control is taking out $200 million of cost net of inflation. And not much of that is really helping us in the first quarter. There are some of the unmet manufacturing activities that we're executing on, but even that is being implemented through this quarter and the operational improvements flowing the inventory, and those benefits won't flow out until they start moving into the second quarter. So the vast majority of that $200 million gets spread across the 3 quarters. So that's a big step up Q1 to Q2.

The second one is how will spreads improve. Now we've had tremendous success in being disciplined and successful in managing our pricing with just great commercial excellence across all parts of the company. It's pretty extraordinary when you think about the amount of inflation that we faced. Last year it was about $1.3 billion of inflation, where at the beginning of the year we didn't really expect that much inflation if we go back to our January call of last year. And if you look at it on a 2-year basis, it's $2.4 billion of inflation, if you even go back to 2019 to '22 $2.0 billion of inflation. So a significant amount of inflation, and we've caught up with most of that and across that multiyear time frame. We certainly kept up with it through last year.

So as you go to each segment, the story is a little bit different. So Advanced Materials is probably the most important one to start with because it has a pretty significant tail when in spread. When you think about they had one of the most challenging raw material and energy environments across our segments with VAM and PVOH up 45% relative to '21 PX, up 40%, energy up 70%. Now they kept up with that inflation with 13% increases in price, but they didn't improve spreads. And if you go back to where we were at the beginning of last year, we had the intention of recovering spread compression in '21 of about $100 million. Now we didn't get that, but we did keep up with inflation.

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And we're starting now into this year at a much higher altitude with the prices that we've achieved in keeping up with this inflation. So as we look at this year, we see that this segment is going to have a pretty substantial tailwind in raw material and energy. And we're not trying to be too optimistic about this. If we just use the -- where raw materials have already come down in PVOH and PX for the first quarter of this year. And think about the energy off of the natural gas forward curve for the year, that's actually quite a bit more spread tailwind than what we would have thought last year of that $100 million because of the higher altitude. So that's part of it.

And again, that shows up as a step up as you move into the second quarter. There's a bit of it that flows through the first quarter, but most of that is in the second quarter through the fourth. With Fibers, much shorter cleaner story, which is you had a lot of challenges and inflation here as well, both especially in energy. And the market, the customers have moved to being worried about security and supply. So we've been very successful in increasing prices last year as well as contractually securing much higher prices this year to make sure that margins are back to sustainable levels to support our customers. And that's $275 million outlook to earnings this year, which is a significant step-up in fact, enough to offset the spread normalization in chemical intermediates that we expect this year.

And then AFP will have modest spread improvement as well, but not as much because they managed spread quite well last year, so they have less upside this year. So you put it all together, that's a lot of spread improvement and a lot of it flows in sequentially into the second quarter. So that's a big step up. The third segment is volume and mix, and this is more of a mix of what happens with the economy versus what's in our control. Destocking at some point is going to end. We're assuming right now that it predominantly ends by the end of this quarter for durables and B&C. And so you get a step up of demand going from destocking levels, which are pretty severe to something less than that.

In the stable markets, we cannot see it moving pass that some amount of growth from those markets. Importantly, innovation is something in our control, and we've had a lot of success last year despite of challenges in the economy and securing a lot of new business wins that are going to help this year. And again, that doesn't really happen during destocking. So you got to wait to get that past you to start seeing some of that benefit. And then, of course, there's China recovery. But we're being very conservative and not assuming much of that in our -- sort of outlook that we've provided until we see more proof of it.

So the bottom line is, there's a lot of step-up across these 3 factors. Many of it is in our control. But as you look at the guidance we gave you for the year, given the outlook for the first quarter, I think it's appropriate to sort of look at the lower half of that guidance or how we're going to perform until we get past this quarter and have more insight on all these factors.

Operator

Our next question today comes from David Begleiter with Deutsche Bank.

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

Mark, just on Fibers, can you talk to the sustainability of this higher level of earnings going forward?

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

David, thank you for the question. It's one of the bright spots of the year and one we're excited to talk about. Fibers has obviously been on a tough journey since 2014 when the market has structure loosened up for a variety of factors. But the situation has evolved and changed over time. First is on the demand side. We historically thought about demand declining in the 2% to 3% range. But what we've seen over the last few years is it's only declining around 1%. And partly, that's driven by the strength of the heat-not-burn segment of the marketplace that is growing at 15% a year, offsetting some of the other decline on the cigarette side. China has also stabilized to being pretty much flat to slightly up in demand over the last several years.

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So you've got stabilization of demand, the heat-not-burn market growing, and the heat-not-burn devices require quite a bit more tow per smoking experience than a cigarette. So that's also helping. If you look at in the last decade, we've only been down about 10% of demand as you sort of put all these factors together. And we uniquely at Eastman also have the benefit of the textile growth, providing stability and margins to our business.

On the supply side, there's also a lot that's changed in the last decade. So you can see about 15% of capacity has been shut down or repurposed. That assets that have been retired, the impacts that Russia has had on capacity in their country as well as us repurposing some of our assets towards the textiles growth. And the move to like the slim cigarettes, especially in China, as well as TiO2 cigarettes has actually had a significant impact on the effective capacity. It's much more difficult to make those products, so you lose a lot of capacity, at least 10%, maybe 15% of capacity is lost with that. So the industry has gone when you put those factors together to being pretty high in capacity utilization, where the conversations and then the focus with our customers is how we are reliable, secure supplier for their needs. You have to remember the value of tow and the final price of the cigarette is a very small percent.

So making sure they have it to sell their product at very high margins is incredibly important to them. And that's now the focus. So that's allowed us to get quite a bit of price up last year, so already good momentum, seeing some of that benefit already in the fourth quarter of last year that indicated the trajectory we're on for this year. So we give you these factors as sustainable and improving the earnings quite a bit. So I would say this year is going to be at least $275 million when we put all those factors together.

The other thing that it does is it gives us a much more solid base for our overall cellulosic stream and very strong cash flow to support the investments we're making in the circular economy, not just the polyester side, but we have a huge number of opportunities on the cellulosic side, with our recycling capabilities to take plastic waste into that product also being biodegradable is allowing us to realize why growth in our Naia textiles, we told you a lot about. So you're going to hear a lot more this year around Aventa for food service that has a huge market opportunity to replace polystyrene and the microbeads. So the cellulosic stream is shifting to being pretty attractive and sort of when we put it all together, growth business.

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

And just on cash flow, you mentioned it increased to $1.4 billion this year due to a number of actions you're taking. Can you just sort of unpack those actions you're taking and specifically working capital release this year?

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

Yes, David, this is Willie. I would highlight to your point, basically, in 2022, I'll call it the inflationary pressures consumed another roughly $300 million in working capital. As we look at 2023, we see, call it, an absence of that inflationary pressure as well as we optimize the inventory for the new demand levels. We think there's at least $300 million on that front that we'll benefit from on a year-over-year basis.

Also, as you think about cash earnings, I would say you need to look at higher cash earnings year-over-year as we normalize for the pension and also as you normalize for the variable comp coming back to normal. Those 2 items should put us at $1.4 billion or above, and higher taxes will bring us back down to the $1.4 billion level. So that's a high-level bridge group.

Operator

Our next question today comes from Alex Yefremov with KeyBanc Capital Markets.

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

The price of virgin plastics has been very volatile lately. So has this is the interest in recycled content that you're negotiating changed at all given lower virgin plastic prices and perhaps weaker demand?

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

So a good question. We haven't seen any real change in people's interest when it comes to recycled content. If you think about it, the brands have set out very aggressive goals in '25 and 2030. And the pressure out there for why they set those goals is just increasing, not decreasing when it comes to plastic waste. So consumers are very sensitive to this topic. There's obviously a lot of environmental, NGOs putting a lot of pressure on this; and politicians, both in Europe and in the U.S. are doubling down on sustainability, climate impact, plastic waste and the policies that they're putting forward.

In Europe, you've got extensive policy around plastic waste reduction and recycling that was passed a couple of years ago and the rules are being implemented now that requires you to have 30% recycled content in your packages, if you want to put them on the shelf in '25 and taxes for whatever it doesn't have recycle content in it. So there are significant economic drivers in Europe that are driving brands to be committed to that.

In the U.S., the NGO pressure, the social media pressure on brands is pretty high. And you now have at least 5 states already passing some version of legislation that's driving change like what's going on in Europe, and some of those are quite big states like California. So the policy pressure and almost requirements to do it are there versus pay a tax and from a brand that's easier to be sustainable than pay a tax from a choice point of view. So the brands have these commitments. The other challenge I've got is the mechanical industry is not remotely capable of supplying the recycled content that's needed by this 2025 time frame back into food grade, while material gets recycled down into other applications like textiles and park benches, et cetera.

But they -- but to get it back to food grade of that quality mechanical recycling just can't meet these goals. So the need for our capability is very much there. The brand engagement is very strong. And we've seen tremendous success already on the specialty front, as we've shared with you with the 1,000 opportunities that we're pursuing with customers around our first plant here in Kingsport. But on the PG side, like the Pepsi contract that we just accomplished, we see that the central part of actually solving this crisis.

The other thing I would note that a drop in demand in short term -- Yes. I just forgot mentioned one thing on the rPET, if you're looking at short-term demand and it's dropping, that's actually not about packaging. It's the carpet people and the textile people having such low demand. They were also buying clear bottles, and they're not buying those clear bottles anymore for their feedstock. And so that's why short-term demand is coming off is purely what's going on in the durables and building construction sector has nothing to do with packaging.

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

And just a follow-up on Advanced Materials, Mark. Do you need raw materials to come down from where they are today to get to your targets of be meaningfully up versus 2021? Or are you assuming sort of current spot raw material prices pretty well for the rest of the year?

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

Yes. On the spread assumption that we've got and how Advanced Materials improves, we're assuming that we don't have another inflation crisis like we did last year, right? So again, the PVOH prices were extraordinarily high because the VAM producers, half of them in the U.S. were unable to operate for 5 months. So we had prices for some periods of the spring and the summer were double because of that extreme market tightness. And we had to buy a lot of very high-priced material from the spot market out of Asia to continue to supply our customers.

So getting rid of all that market tightness, which is where sort of VAM and PVOH prices have now gone to some degree. I think there's still more coming down, but we're just using where we are today for this quarter and how we project spread improvement versus last year. Same with PX. We're not assuming a dramatic improvement relative to where PX is now. You could look at 6 million tons of PX capacity coming online this quarter in China, and PX prices could get lower, but that would be upside. We're not banking on that in our outlook. We are assuming energy costs get lower, as I said, we're using the forward curve on natural gas for that.

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But that's what's in the sort of outlook we're giving you for this base case. Could things be higher? Sure. but that would require a pretty significant move up in oil from the sort of $80, $90 range we're in. And I think we feel good about this base case given sort of the world that we're in and the macroeconomic challenges that we face right now.

Operator

Our next question comes from Michael Leithead with Barclays.

Michael James Leithead - *Barclays Bank PLC, Research Division - Research Analyst*

First question, just on the circular plastic build-out, a bit of inflation so far, and you still need to break ground on the second and third facility. So can you just talk about what you're doing today to help make sure we don't get further CapEx creep year over, say, the next year or so?

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

Sure. So there's a lot that we've been doing to manage a difficult capital construction environment last year for the Kingsport plant and have done a great job in keeping those costs under control. A little frustrated by the challenges in getting craft labor to get the plant sort of completed here, but the cost control is working well. And we're confident we'll get this plant up and running early summer.

When it comes to the next 2 projects, there are a couple of things we're doing. One is some of the commentary we provided in our prepared remarks about how we're building these plants. So we had a design for building these plants where we were always going to start out with 100 KMT of capacity, but designing them upfront to expand to be 50% bigger when you add it on the second phase. We've switched to taking a more standardized approach to sort of say, look, we're going to build identically what we're building here in Kingsport in France and in the second U.S. project with Pepsi. So a very standardized approach to leverage all the engineering, procurement, construction approach to sort of build a replica of what we're doing here in a very efficient manner. So that's one way we're going to help to keep the capital cost down.

Now to be clear, we're still spending capital at the site to make sure the infrastructure is in place for what we will do is double the capacity at each of these sites over time after we get the first site -- first modules up, if you will. So we're actually sort of expanding what we think we can deliver between now and 2030, doubling it versus, call it, 50%, but we're taking a more standardized approach. And this also allows us to take a lot of insights we have around how to improve the technology on energy efficiency and feedstock robustness into that second phase in this more modular approach. So there's a variety of benefits.

The other thing we have really factored into our capital estimates yet is a slowing macroeconomic environment should create some deflation in the construction industry. We're already seeing it in the price of steel and pipes and things like that. So materials are going to get cheaper. I don't think the cost per labor hour is going to go down. But I do think we're going to have more availability of resources, higher quality resources. So productivity will improve in materials and equipment, will probably come off in price. So that will help also keep control on the CapEx numbers.

Michael James Leithead - *Barclays Bank PLC, Research Division - Research Analyst*

Great. And then second, just on Fibers and the new contracts there. If I remember, most of your tow business was moved to long-term contracts a few years ago. So is this new pricing just reflective of a portion of your current business that we'll see further resets over the next 2 years? Or is this a big reset for almost all of your business here today into '23?

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

It's a big reset for most of our business. So about 2/3 of our business is on contract. A lot of that is multiyear. Some of it is annual. And even with what is not on contract, it's pretty firm agreements when it comes to volume on an annual basis. So we -- just the nature of when all these contracts

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started to turn over happen to be last year into this year that gave us the opportunity to have these negotiations and increase these prices. That's why you're seeing this all happen now as opposed to a year ago when the market was already started getting tight, but we didn't have the contractual flexibility to make these changes until now.

Operator

Our next question today comes from Vincent Andrews with Barclays -- sorry, Vincent Andrews with Morgan Stanley.

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

Mark, could you talk a little bit more about, I guess, 2 things. One, I was struck by the consumer durables comment in Advanced Materials where your volume was down 40%. That just seems like an enormous number. So could you just talk a little bit more about how that's actually impacting Advanced Materials business and what the -- sort of cadence of improvement is -- it's going to be? And then also, could you just sort of detail a little bit your assumptions about the auto business for '23? I think I read that you've got expectations for sequential decline from 4Q to 1Q and some modest growth overall in '23. But is there anything changing about the customer mix of your products for '23 in terms of the cars they're building and the tech that's in them or anything like that, just given, it seems like the automakers are starting to focus on different things in a more recessionary environment.

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

Sure. So both are very relevant important questions for us. The consumer durable business is incredibly important markets where we sell our Tritan at very high margins and have had tremendous growth over the last decade. What I can tell you, and we've been doing a very deep dive on what's going on in the fourth quarter, as you would expect, it's entirely market-driven. When you look at some of what's going on in the specific parts of the market we're in, which is small appliances, housewares, electronics, that part of the durables world. It's just been declining really for quite a long time, right? So the underlying market started declining in the second quarter of last year modestly.

And then as people started switching to travel, leisure versus buying a lot of durable goods. You saw that in the announcements from Walmart and Target, if you go back to May. And what we didn't really -- fully appreciate is just how much overstocking the retail sector was doing in ordering from everyone who could supply them because they were so short of material and then suddenly it all showed up and they had a lot more inventory to get -- to get out. And with inflation being so high, the consumer durable sector is the first thing people stop buying. And you can see that in the semiconductor data, you can see that in the electronics where they're dramatically down.

So when we look at what's going on in the end market, you can see a lot of evidence at the primary demand level of demand being off, but not nearly as much as us, right? So the retail sales data will show our direct end markets might be off 10%, 15%. And we're up 40%. So the rest of that is, by definition, destocking. And that's because of these retail inventory channels that are so overstuffed, and it just took a while to get that momentum to try and pull down production through the entire chain. So it's challenged. And it's continuing into the first quarter, and we expect it to be equally challenging this quarter as the fourth.

But at some point, it's going to end. And from what we can see so far, we think they will get this under control mostly by the end of this first quarter, and then you've got a big step up in demand when the destocking is over to sort of lower demand than what is normal but still a lot better than 40% down, and that's part of the step-up in earnings for Advanced Materials as you move into the second quarter.

On the auto side, demand, we're being, I think, conservative probably a little bit more conservative than what the consultants would say about demand being slightly down in the fourth quarter -- in the first quarter and not improving much for the year. So if we're wrong about that and production improves more, that's a lot of upside because those are very high-value markets that we serve in our earnings. But the shift in the market, to get at your question, Vince, it is really important. That shift is very favorable to us. So we now got about 10% of our sales going into EVs at very high margins. You have to remember that each EV is about 3.5x more value for us than an ICE car. There's a lot more class in an EV car and

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a lot more functionality. They're putting in it from acoustics to solar rejection, to heads-up display, et cetera. So the value capture there is tremendous on a mix lift basis.

So the EV trend, and we are aligned with the top players on this with our products is a significant opportunity. I'd also say head-up display in general, not just in EVs, but all cars have a lot of growth momentum. It was a big mix uplift last year and even though down market, and we think that trend is going to continue and accelerate into this year as a result of the semiconductors, there's a lot in the HUD. There's a lot of times if you were trying to buy a car last year, they would let you order the HUD because of semiconductor limitations, that's going to resolve. And so we see the HUD market picking up. I'd also note that, that's in large. The paint protection business and the performance films business is doing fantastic, very strong growth, very high margins. So we got a lot of mix uplift relative to the underlying market in auto that helped us offset some of the challenges last year and certainly will be a significant lever versus last year into this year.

Operator

Our next question comes from Jeff Zekauskas with JPMorgan.

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

Of that $200 million in cost savings, how does it split between SG&A and cost of goods sold?

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

Jeff, thanks for the question. I would highlight we have 2 major pillars within this. We've highlighted roughly $125 million of this. We'll be taking from our operations, which would include manufacturing and supply chain and then $75 million, I'll call it, more in the non-operations which would be SG&A and primarily. So I'll break it down a little bit for you. So on the $125 million, what gives us confidence is we expect more efficient operations as we run at lower rates due to moderating demand. As you think about the supply chains as well as our planned and unplanned schedule last year, we expect a significant improvement. I also think we've demonstrated even back to the COVID environment that we also leverage a pretty variable cost structure when it comes to leveraging overtime contractors, and we're already taking the actions at the end of the year, starting in Q1 to change that cost structure to the current demand levels. And we're very focused on operating at the most efficient level from an operations standpoint as we assess the demand environment that Mark has highlighted here.

On the supply chain and the network optimization, we see $30 million to $50 million in that space as you think about us having to air freight, use inefficient modes on a year-over-year basis. So a substantial increase on that front. Also, as you saw in the prepared materials, we expect to have roughly $25 million lower maintenance year-over-year. And we're also looking at our asset footprint and as you saw, some restructuring charges there as we look on a go-forward basis. So that's on the manufacturing front. On the non-operations I would highlight, we've already, I'll call, reduced discretionary, and we're starting that here in Q1. So as you think about external spend versus our workforce reduction, that's about 50-50 from a cost impact on a year-over-year basis.

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

Okay. And so these are net reductions. So does it mean that SG&A should go down $75 million all in, in 2023, exclusive of the $110 million lift in pension expense? And can you explain what the event was that caused the $110 million lift in pension expense?

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

Okay. So let me break that into a couple of parts for you, Jeff. So on the pension, I'll hit that first. That will not impact SG&A or manufacturing, it's set on our income statement within the EBIT. There was 2 drivers as you think about pension, and they're equal. So the pension and interest to costs, we had lower discount rates. You can think about 200 basis points on the interest cost in 2022, that will increase over 500 basis points, so a

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300 basis point change on the interest cost. Our assets are lower year-over-year as you think about the market basically being down about 20% versus our assumed return of about 6%. That's about $50 million each is what I would roughly say there.

On the SG&A question, our variable comp will be normalizing. So that will be a headwind on a year-over-year basis that we expect that to be substantially offset by the $75 million.

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

So Jeff, one way to think about sort of the waterfall across the businesses and the cost actions is, the cost reduction actions are sort of equal to offsetting both the pension costs and the return to variable comp and inflation, right? We put all that sort of together. So sort of the fixed cost structure, if you will, is flat. The Fibers improvement offsets the normalization in CI. So you have to have a point of view that the 2 specialty businesses are able to deliver earnings growth over the annualized FX headwind for this year. That's another way to sort of think about how we get to sort of flat EPS, including pension is those specialty businesses have to offset basically inflation this year and growth relative to last year. We've given you the waterfall on sort of where that growth comes from.

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

Is the pension expense, cash or noncash?

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

It is noncash. So there's no impact on our cash flow.

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

That's why we held the guidance where we did just talk about growing earnings of the segments.

Operator

Our next question today comes from Frank Mitsch with Fermium Research.

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

Willie, I'll give you a shout later on and talk about how Fermium can help on your pension plan asset returns. Mark, you mentioned in the prepared remarks that you're going to keep the cracker down through the first quarter. Can you talk about some of the factors and the outlook that you're seeing on the CI side of things and when should -- should we expect that the cracker will come back up in 2Q?

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

Yes, our expectation is the cracker starts to come back up in Q2, anyway you can do the math on sort of cracking spreads right now last year. Remember, our crackers are a bit different where they're highly oriented towards propane versus ethane. And we're trying to make as much propylene as we can and as little ethylene as we can with the investments we've made in switching into RGP, which we're doing as much as we can because the ethylene market is very economically challenged for basically at cash costs on bulk ethylene.

But as the propylene markets are starting to improve, you can sort of see that through January. The spreads -- the crackers are recovering as we go through this quarter and that feeds into our expectation that, that is likely to continue or hold and we bring the cracker back up. Demand right

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now continues to be challenged. So we don't really need as much of the output, which is why it's easy to sort of make this decision in the moment for both the demand and the crackers in my point of view. But we expect demand to get better in the second quarter as well as the spreads to continue to sort of stabilize at these better margins. So that's sort of how we're looking at it at this stage. You have to remember that propylene prices are well below and it is sort of historical norm to oil. They're very depressed. If you go run that analysis, it's pretty extraordinary. So we're really just trying to get back to a more normal relationship to the price of oil on company.

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

Terrific. And then if I can ask about the second methanolysis unit in the U.S. You'd indicated in the remarks that you've made progress on permitting, but you haven't selected a location as of yet. Can you just talk about how that process plays out? I mean I don't doubt that communities would welcome a methanolysis unit in a locations, which can you talk about a little more color there?

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

Sure. So we -- first of all, we're really excited to have this relationship with Pepsi that baseloads this facility and gives us the confidence to move quickly on this project. We are looking at multiple sites. As you might imagine, we're looking at existing sites we own and whether we can leverage all that brownfield and existing infrastructure costs down in Texas. But we're also looking at some other brownfield sites in some other states that could be attractive and evaluating the capital efficiency of each of these sites, the feedstock, benefits of each site as well as the incentives that different states are willing to provide to promote investing in the circular economy and playing a role in solving this environmental challenge.

And the engagement, frankly, across the states has been really high. And as you said, I think they're all quite interested and excited to sort of participate in this kind of a green project. But we haven't finalized that. I'm hoping within the first half of this year, we'll have that finalized and then start moving very quickly on the -- on this -- so not just incentives, but the permitting and the site development and everything else. The advantage of our new sort of standardized approach in building these plants so allows us to start the engineering now without knowing what the site is going to be. So we're already spooling up engineering for this site and designing it. And then we'll do from what is -- what we call inside the battery limits, the actual operating units of this plant, the sort of infrastructure will obviously be dependent on which side we finally select.

Operator

The next question comes from Kevin McCarthy with Vertical Research Partners.

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

A couple of questions on your capital deployment. So in the prepared remarks last night, Mark, I think you mentioned your methanolysis investments in the aggregate would cost $2.25 billion, which is up about 10% relative to your prior projections. Can you talk about how that flows through? Is it going to be ratable over the next 5 years or some other shape? And then related to that, are your returns still the same? In other words, are you able to perhaps extract a larger premium to offset the higher project costs? And I guess more broadly for Willie, do you think CapEx will run $700 million to $800 million over the next several years? Or again, is there a different shape to that as you execute on these investments?

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

Kevin, thanks for the question. Yes, I would highlight here in 2022, we already invested approximately $300 million as we think about our circular investments that we highlighted in the prepared comments. So as you think about approaching $2 billion over the next 3 to 4 years. In 2022, '23, we're increasing our CapEx budget to $700 million to $800 million, that includes a step-up on a year-over-year basis. And yes, as you think about a normal, I'll call it, a large capital curve, it will definitely be over $800 million through that time horizon and probably will peak around $1 billion to $1.2 billion.

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

Okay. And then the market?

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

As I think about broader capital allocation...

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

Sorry, go ahead. You're talking about the returns, we didn't answer that question...

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

Yes, I was just going to follow up on that. I think in the past, you talked about 12% plus.

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

Yes. So on the return front, to be clear, what we announced in the prepared remarks today around the design of the facilities is the same as what we had in our economics back in 2021 innovation thing. So that the first phase was always going to be the -- around this 110,000 tons of waste being processed. And so the $450 million EBITDA has not changed, and we feel more confident in as we're actually securing prices with contracts and securing feedstock, both total ability as well as what it's going to cost supporting those economics.

The capital costs being a little bit higher than what we had talked about that sort of 10% increase that we discussed in our prepared remarks don't affect the returns. We said where our returns are above 12% for the second, third project, above 15% for the first project. We said greater than we have room to absorb some of these challenges because you always expect them to happen, frankly, when you're doing these kind of capital construction projects, and we always want to make sure we have robust plans for the economics to deliver returns.

Operator

Our next question comes from Matthew DeYoe with Bank of America Merrill Lynch.

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

One, I have missed this, but if we're looking at the Kingsport methanolysis unit, can we just walk through the progression from cost to profit how much commissioning costs in 2023 numbers? What do we think for how that moves to profit in 2024 and getting that full run rate earnings on that facility?

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

Yes. So I would highlight as you think about the startup, we're talking about roughly $35 million, including, I'll call it, the depreciation as it starts up in the back half of the year. So as we think about the first project, you should be getting to a more normalized run rate of growth in 2024. And by the end of '25, we would expect to be close to the full run rate of the plants, which we've highlighted could approach roughly $150 million per project.

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

All right. On that end, would that mean that 2024 is just neutral? Or would you see EBITDA? And then I guess just a question, you don't really talk much about buyback for next year. And I know CapEx is going up, but it still seems like maybe you have $200 million, $250 million of after dividend cash flow. Do we assume that goes to buyback or I mean your leverage is fine. Can you do an access of that?

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

Yes. So definitely, we expect 2024 to be accretive from our Kingsport circular methanolysis projects. So we're confident in the progress. You'll see revenue here in the back half of '23. That turns into earnings and growth in '24 and approaching those run rates as we expect these plants given, I'll call it, the market excitement that's around that in the 1,000 leads that we're already working on. As you think about...

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

Capital?

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

On the capital front, versus share buybacks. So yes, we're on the capital allocation, our priorities remain the same. We increased the dividend here in the fourth quarter for 2023. Also, as we think about $700 million to $800 million of CapEx, and we're looking at prioritization of bolt-ons versus share repurchases. We're going to always fully leverage our cash flow to give shareholders return. So there is that capacity and we will put the cash to use.

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

We always have this debate around best uses of cash in there on a principal basis. When we look at the circular platform, the capital we're deploying there has substantially better returns and valuation potential for the company than buying back stock today, and we think that's the appropriate way to deploy the capital versus buybacks on that front.

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

Sure. But that's not contemplated in the earnings guidance, right? Or is it?

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

What?

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

Any accretion from like a deal or a buyback or anything like that? That would be a huge upside.

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

So, just to highlight, obviously, we executed $1 billion of share buybacks in 2022, both from our operating cash flow and the divestiture proceeds. So we will have, I call it, EPS accretion as a result of the full year benefit from that. Right now, that's primarily offset by higher interest expense.

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Operator

Our next question comes from Mike Sison with Wells Fargo.

Michael Joseph Sison - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Analyst*

Mark, just one question. You spent a lot of time over the last several years transforming the portfolio to more specialty assets. And when you think about the performance in the second half, kind of the start to the first quarter, what can you point out to folks that demonstrate that maybe the performances has that these special characteristics or maybe it's more the bounce back in the second half? And clearly, your multiple is -- where it should be, if it's the case. So just curious what your thoughts on that.

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

Sure. So first of all, we think we've made tremendous progress in improving our portfolio over the years. We've obviously divested a lot of commodity businesses, acquired some great specialty businesses. In the past, if you go back to that sort of 2011, 2012 time frame as well through the acquisitions to 2014 and the divestitures more recently and optimize the portfolio. So I think we have a very good track record and portfolio discipline. I think last year, as you look at it, it was a uniquely challenging year for 2 reasons that you have to sort of consider in judging a history and a future of this portfolio. Obviously, the fourth quarter turns out was the entirety of the earnings decline from a volume mix point of view. So we were actually flat in volume mix leading up to the fourth quarter and the entirety of the volume mix decline was driven there.

And because of some of the very unique operational challenges we had last year, those limited our ability to deliver growth, especially in Advanced Materials. So those 2 factors sort of constrained what was on track at the beginning of January before the Ukrainian were in rapid inflation, everything else was going to be a really impressive year of earnings growth. So I wouldn't sort of overwork on trying to interpret too much into the 2022. Our challenge and our proof point will be if we deliver this performance that we've just sort of suggested in our outlook discussion today, in this kind of challenging economic environment, that's a really strong endorsement about the quality and strength of the portfolio to manage through these challenges.

There's no question, we create a lot of value in markets that have economic sensitivity, whether it's B&C or durables or auto. Auto, all last year was at recession levels. 80% of 2019 is not a good year for auto demand. And we managed to actually still do reasonably well in that business on the volume mix side. So I think we feel really good about the quality of the portfolio from a volume mix point of view and its ability to deliver innovation and growth through all kinds of platforms, not just big circular platform we've been talking about, but cellulosics has probably $200 million upside when we go forward. over the next 3, 4 years.

And then the interlayers business, as I discussed earlier, has a tremendous amount of growth. PPF is great. Coatings add has a lot of sustainable introductions to the marketplace, semiconductor leverage we have in high-purity solvency. So growth innovation is very much there as the specialty business should have to deliver good results. Margin stability actually is on the spread side, quite good. When you look at the portfolio, how it combines together to deliver in a steady spreads at the favorable margin level. And we've demonstrated very good commercial discipline. So what you really got last year is a manufacturing recession in 1 quarter and a huge currency headwind for the year. And then some limitations on how much growth we're going to have with some one-off operational issues. So I don't think there's any lack of differentiation in this portfolio or quality of that. And I think as we get through this year and start delivering pretty significant growth next year, assuming we put this recession behind us, is going to be very attractive for owners.

Operator

The next question comes from John Roberts with Credit Suisse.

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

You had an ethylene/propylene flex project for long view. Has that been delayed? And if you had that in place, would you have still shut down the cracker?

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

So we're not yet constructing that project. We are completing the licensing and the early engineering work around being able to pull the trigger on that project as soon as we feel it's appropriate. We have a lot of requests for capital across our portfolio back to valuation discussion that I just commented on. It's not just circular that has a lot of capital opportunities for very attractive returns on investment. Our whole specialty portfolio has those opportunities as well. And while certainly, the current economic challenges are there, we don't see a lack of growth opportunities across our portfolio on the specialty side. So those get priority call on capital relative to the ethylene to propylene investment. It's one that we will for sure do when it's at the right time, but we're going to have to be thoughtful about how we manage our overall CapEx budget.

And to answer your question, if E to P was in place, we would not be -- we would not have left as cracker down. Remember, we had it down for maintenance. We just didn't bring it back up after we completed the planned maintenance. And we would certainly pin down for the maintenance in Q4, but would have been switching to E to P right now.

Operator

Our next question comes from Laurence Alexander with Jefferies.

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

Two quick ones. First, on the renewables capacity, will that inventory build show up on your P&L? Or will it be separate? And can you give us a sense for the magnitude? And secondly, on the end market comments that you're hearing from customers, I guess it looks from your presentation is if the overall theme is the -- industrial recession driven by destocking to recalibrate, but underlying demand is pretty solid -- is pretty stable outside the construction markets. How confident are your customers on that? Or -- and when do you think they need to -- or -- and how much warning do you think you would have if they need to recalibrate?

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

So I'll let Willie take the first question. I'll take the end market.

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

Sure. On the Kingsport methanolysis project, obviously, we've built as a supply chain. We already have the key raw materials and lease cycle materials as part of our inventory here at year-end as we're preparing for a startup next year. So you can think about there's no significant impact of transitioning from fossil fuel feedstocks to recycled content as we go from '22 to '23. As we think about our projects -- second U.S. project and the project in France, again, we could have different operating models in the regions that those are not significant working capital builds.

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

When it comes to your end market question, when you think about end market exposure in 3 buckets, right? The one that's most impacted by this sort of manufacturing recession is durables and building construction. The 40% down in durables, as we talked about earlier, 40% down in building construction in the fourth quarter in AFP. So those markets are being very heavily impacted. And that destocking relative to the retail data is pretty

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significant relative to end market demand, which is still quite weak. So there's that. We do think destocking by definition as in at some point. It's hard to say exactly when, but we've told you what we're assuming, and you can factor what you want to believe into the models.

When it comes to auto, the auto demands are already at recession levels all last year, right? So that second bucket, which is a huge driver of profit for the industry as well as for Eastman, probably has limited downside and more upside as we go through this year, even though we are going into an economically or already in an economically challenged area where consumers have discretionary choices on where they want to spend money. So we do think that's going to, sort of, be stable and sort of modestly improve. And within that mix, I should have also said earlier, we are levered to the luxury market with all of our products because they're very high-value products that we're selling. And that part of the market is likely -- has held up better last year and certainly going to, I think, hold up better this year in sort of these economically -- sort of expensive times when it comes to interest rates.

And then the third bucket, which is about half of our revenue is what we call our stable markets. This is medical, consumables, ag, food, feed, all these sort of end markets are water treatment that are very stable. Now we saw quite a bit of destocking even in the stable markets in the fourth quarter across the entire company as people were trying to get rid of high-cost inventory, generate cash for themselves. So that was a big part of the headwind too less than a percent basis, but happening everywhere as part of the challenge. There, we see into that destocking playing out because their markets are stable. So there's not a lot of destocking they can actually do. So that starts to really help stabilize as we go through this quarter into second -- the overall revenue base across the company.

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

Let's make the next question the last one, please.

Operator

Of course, our final question today comes from the line of P.J. Juvekar with Citi.

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

So Mark, on methanolysis, you mentioned your CapEx is up 10%, but you don't expect a huge change in the returns you expect. Are you passing on the increased cost to your customers? And also, the plastics are cyclical. And so you -- if you want to get steady returns there, are your customers willing to take the cyclicality of the plastics and volatility so that you can cap steady margins?

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

Yes. So I think from a spread point of view, the way we're sort of contracting into the PET market is with our -- what we call our circular contracting model, going to provide steady spreads between the cost of feedstock and energy and the price of material. So from a spread point of view, we really expect to have quite good stability, I think Airgas company kind of model. Demand, of course, is still subject to end market demand. So when it comes to sort of the volume, there's always going to be some variability, but we're going into packaging and the consumables. So the variability in that volume on an annual basis year-over-year is pretty stable, right?

So I don't have a lot of volume concerns there. When it comes to the specialty side of this circular platform, we're not changing the end market sort of structure in both demand or how we do pricing. We're just adding recycled content as another dimension of differentiation to Tritan and all the other copolyesters in the cosmetics everything elsewhere selling. So we'll still be sensitive to demand changes when it comes to the circular platform that we'll be capturing higher margins relative to what we currently realize in these products and growing total volume quite fast, right? One of the reasons we win in the marketplace is high-value growth, driving mix upgrade against such cost leverage, right? That is very true in good times, and this will lead to much more accelerated growth from these kind of products to fixed cost leverage.

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But unfortunately, face downtimes like the last fourth quarter and the first quarter of this year where that mix is a headwind. But when you look at the upside in our stock, as you get through this, not just for circular, but for just market recovery, there's a huge mix upside for our company as you go into the back half of this year and '24 when you think recovery is coming, which we demonstrated coming out of 2020.

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

Mark, the Airgas or the industrial gas model hasn't really worked in plastics. What gives you confidence that this would work this time? Is it because this is such a specialty product and the consumers want it or the customers want it that you can have that kind of contract structure?

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

Yes. So as I said, in specialty, it's just our current model. But when it comes to the PET, that's where the industrial gas model concept applies. And yes, it's a unique offering, right? We're the only large-scale company on the planet, especially in North America and Europe, who's offering recycled content from hard recycled plastics. And when you get to the food grade industry, mechanical can't remotely meet their needs. And someone has to plug that gap if they're going to hit their targets, and we are way ahead of our competition in being able to provide that service.

And that's exactly what an Airgas company does to provide a service to convert a product into a highly needed input. And that's sort of where we're at today, and that's our confidence as we go forward into these 3 projects. And that's why we continue to maintain a discipline -- not building these kind of facilities unless we get these kind of contracts, because I'm not getting back into as you said, P.J., the traditional plastics business at high margin volatility, we just won't do that.

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

Okay. Thanks again for joining us today. We really appreciate it. I hope you have a great day.

Operator

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

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