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EMN.N - Q2 2023 Eastman Chemical Co Earnings Call

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CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

Arun Shankar Viswanathan *RBC Capital Markets, Research Division - Senior Equity Analyst*

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

Frank Joseph Mitsch *Fermium Research, LLC - President*

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

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

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

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

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

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

Patrick David Cunningham *Citigroup Inc., Research Division - Research Analyst*

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

PRESENTATION

Operator

Good day, everyone, and welcome to the Second Quarter 2023 Eastman Conference Call. This conference is being recorded. This call is being broadcast live on the Eastman website, www.eastman.com.

I'll now turn the call over to Mr. Greg Riddle of Eastman Investor Relations. Please go ahead, sir.

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

Thank you, Elliott, and good morning, everyone, and thanks for joining us. On the call with me today are Mark Costa, Board Chair and CEO; and William McLain, Executive Vice President and CFO; and Jake LaRoe, Manager, Investor Relations. Yesterday after market closed, we posted our second quarter 2023 financial results news release and SEC 8-K filing, our slides and the related prepared remarks in the Investors section of our website, 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 second quarter 2023 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 2022 and the Form 10-Q to be filed for second quarter 2023.

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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 second quarter 2023 financial results news release. As we posted the slides and accompanying prepared remarks on our website last night, we will now go straight into Q&A.

Elliot, please, let's start with our first question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today comes from Josh Spector with UBS.

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

I guess, first, I was just wondering if you could talk about the cadence of earnings here in the second half. Obviously, you're talking about a number of inventory adjustments impacting 3Q. If you could talk towards what you're thinking more of the steady state looks like, whether it's 4Q or maybe beyond that, and what that implies for longer-term earnings CAGR here?

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

Thanks for the question. So there's a lot embedded in that question about the back half of the year and how that indicates where we go into next year. So first of all, I'd start with -- we obviously, in April, thought demand was going to be better in the back half of the year, which was principally an assumption based on destocking really being complete by the end of the second quarter.

Obviously, we and everyone else in the sector has come to a different point of view that while demand at the primary level, I don't think is changing that much. It's not getting worse in our perspective, and I haven't heard anyone else suggest that.

We are expecting that there's a lot more destocking that continues to go on in some end markets, which has really been the impact to our outlook in the back half of the year.

So some areas, whether it's this year or next year, for example, automotive, we have solid growth in this quarter. We expect that to continue to be solid through the back half of the year. And there's so much pent-up demand. And when you think about '24, I would expect it to continue to be a tailwind next year relative to this year. So that market -- aviation, same story, in very good shape.

You have a lot of sort of stable end markets, where demand has been off in that sort of 3%, 4%, 5% range. When you look at all the fast-moving consumer goods companies out there fully recognizing that they're holding price and being very disciplined to expand their margins that way with the raw material tailwinds, and accepting that they probably wouldn't gain much volume if they reduce price. So disciplined, like we're maintaining, frankly, in our specialties.

But in addition to that, they're managing cash, too. So we saw an additional sort of 8% to 12% destocking on top of that demand in the fourth quarter, first quarter. But fortunately, as we go into the second quarter, lessening on that destocking and expect much less destocking in those kind of stable markets like packaging, personal care, water treatment.

So that feels like it's moving in the right direction as we go to the second half. And of course, that would continue also into '24.

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When you look at the consumer discretionary markets -- actually, I would take 2 other stable markets just to deal with them. So there's a couple that also took some sort of extreme negatives in additional destocking in Q2, which was packaging and medical in the Advanced Materials segment. And that's -- they were carrying a bunch of safety stock from last year. Demand wasn't improving as they expected.

And so they really started destocking in the second quarter, but they also seem to have addressed their issues predominantly in the second quarter. So that's also expected to get a bit better as we go into the back half of the year, as that destocking reduces through the third quarter and certainly seems to have run its course in by the fourth.

So again, improvement relative to next year, especially when you think about all these markets had a certain amount of destocking that won't repeat in '24, that's a tailwind. So the 2 bigger markets that drive a huge amount of value for us on a profitability point of view, like automotive that had the most demand impact is sort of in the consumer discretionary area as well, like durables and building construction.

When you look at the durable market, that's the one that's gone through the most extensive destocking of any market. And it really goes all the way back to last May of last year when the retailer sort of got 2x the amount of inventory they needed because they were buying everything they could think of to -- because of supply chain prices, and then they started destocking over 14 months ago.

That bullet finally hit us in the fourth quarter of last year, really knocked us down about 40% when the underlying market was only down 10% to 15%. So a lot of destocking. Got even worse, 10% worse, into the first quarter. And then fortunately, when we saw that destocking start to abate in the second quarter, we got 22% better in the second quarter versus the first quarter.

So we saw momentum there. You just don't see it in the results because of the medical and packaging destocking that occurred. So that destocking will continue to lessen as we go into the back half of the year and be another tailwind as you go into it.

And then, of course, building and construction, I'd say, is one that's been doing some destocking this year, demand is down. And we expect that to be sort of flat to the first half, because that market still has more action taken. There's also maybe some more help with first home builds.

So there's a spectrum of things going on when you look at it, but it's -- each of them sort of add up to less destocking, but it's not as much as we had hoped for in April, and that's really the predominance of how our volume forecast came down, which is the entirety of our earnings reduction when you combine that with the need to take inventory actions for this lower demand outlook to make sure we hit the $1.4 billion of cash.

So all those then feed into a year next year that's going to look better, right? When you don't have all this destocking going on, which we're assuming for '24, you have some normal seasonality coming back into the demand outlook for next year that's going to help improve things.

And you've got the recovery of all this volume in our most -- sort of down markets are our highest value markets, right? So it's been a huge mix hit to us this year. And as we've shown in past recessions, when the mix comes back and if there's a little bit of restocking, the high value of these markets drops to the bottom line pretty significantly, especially with the costs we've taken out of our fixed cost structure. So it all comes together, which is building momentum in the second half to having a much better year in 2024.

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

Okay. If I could just ask it very quickly then, so your volumes were down 15% in the first half. What's your baked-in assumption on the second half, all those things put together?

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

You're saying what is our specific volume forecast that we've got as a combined company for the second half relative to the first half? Is that what your question is?

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

Yes. Are you assuming down 15% for the majority? Down 10%? Down 5%? I'm just trying to get a kind of quantum of what you're considering.

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

So as we look at it, I think it's -- altogether, the volumes in the back half of the year are going to be a bit less than the first half of the year, but I don't think we're going to provide a quantitative number to it. it's basically just a little bit down, when you put it all together.

The real headwinds in the back half of the year is the -- from a sequential point of view, first half, second half, the entirety of our earnings decline is the inventory management, right? So that $75 million sort of additional headwind sort of aligns with sort of where our earnings outlook has now moved.

So volumes are relatively stable when you put all the ups and downs, right? So some down in AFP, some up in AM, stability in Fibers and CI, sort of a flat volume number from a sequential point of view.

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

But Josh, I would also say the mix should be more favorable, as Mark has outlined, with our durables markets recovering in the back half.

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

And if I just add one more point, which is third quarter year-over-year, the volume mix decline would be less than what you've seen in the first half, but still meaningful. When you get to the fourth quarter, again, on a year-over-year basis, the comp is a little bit different. And so you get to a point where that decline in volume mix is even less still than it was in the first half of the year.

Operator

Our next question comes from Vincent Andrews with Morgan Stanley.

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

In Advanced Materials and in AFP, when you talk to your customers about what's going on volumetrically, what are they indicating in terms of the desire on a go-forward basis, where they want to have inventories and where things might get back to?

And I guess what I'm trying to understand is whether what's going on right now is just sort of a structural reset in terms of how they're going to manage their own business versus something that maybe is just temporary that snaps back.

It's just -- it's been going on for a long time. So it's starting to feel like -- and whether it's interest rates or whatever else has happened, it's just starting to feel like the entire supply chain is doing a reset. So I'm just curious, what your customers are telling you in regards to their sort of medium to long-term intentions in terms of holding inventory?

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

That's a great question, Vincent. And I mean I'll try and keep it simple, since my last answer was rather long. But it's very different by end market on what's going on, on the stability of underlying demand and then what they're trying to do in destocking, right? So a lot of these stable markets, it's more fine-tuning, right?

They -- everyone built safety stocks last year through '21 and '22, and they're trying to generate cash and adjust those inventory levels to different perspectives on end markets. So if you're in the personal care world, medical world, these markets are stable at the end. They may be down a little bit, but they're very stable. So destocking is clearly the entirety of what's going on there in many of those sort of end markets.

When you get to some of these other markets, where the supply chain is incredibly long, like durables, we're making things that go to China, that get made into products that come back to Europe or the U.S. Really understanding just how much inventory is out there through that entire chain is difficult for everyone in these markets. And exactly where end market demand is on these more discretionary markets, I think, is a little bit more difficult to judge.

But what I'd say, we've seen is a couple of cycles, right? So there's a lot of destocking in the fourth quarter. Demand was really low in January, got a bit better through March. And then there was a realization that the banking crisis, people got nervous about what's going on in the broader economy.

And so they went into a really low level of demand in April, which was probably the low point for the year. And then started to do a little bit less destocking -- or a lot less destocking in durables through the second quarter.

So as we get into the back half of this year, I think what happened with customers in the June time frame is everyone assuming the back half was going to be a bit better in our downstream customers across -- in most markets, especially maybe the more sensitive ones, that things would stabilize, destocking after 14 months, to your point, who would have played its course more -- back in June after 12 months.

And they realized they all have that built in their plans, they sort of said that's not going to happen. Demand is going to be flat, which is all of our collective assumption now, and everyone is in destocking mode to that assumption relative to things getting better.

But it's not because the markets are getting worse, Vincent, it's just they'd assumed things would get a little bit better, they're not, and they're sort of correcting for that. And it's important that it's a lack of expected growth as opposed to, I think, things are getting worse. I don't see anyone saying things are getting worse at the -- in the primary demand level. Does that make sense?

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

Yes.

Operator

Our next question comes from Frank Mitsch with Fermium Research.

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

With much of the discussion regarding inventory management and so forth, I'm just curious, obviously, the 10-Q hasn't come out yet, so we don't know where the second quarter inventory levels are. But can you give us an idea where they are relative to the 1.94 that was in the first quarter? And what are your expectations as to when you go through these actions, how much further down will you be drawing your own inventories?

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

Frank, it's Willie. Yes, so as we think about inventory levels, I'll call it from Q1 to Q2, inventories are about flat. So as we think about the level of the supply chains and the demands that Mark has just outlined, we have about $300 million that we would expect inventory to decline in the back half of the year.

That's also essential to getting us to generating roughly $100 million from working capital on a full year basis, and I'm confident that our business teams and supply chain that we have a plan in place that we've already activated to execute and deliver that cash flow.

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

Terrific. And Mark, I was wondering if you could talk to the raw material benefits that you're seeing in your specialty businesses, any way you can provide some order of magnitude in terms of what sort of benefits are you seeing and what your outlook is there?

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

Yes. So I think in Advanced Materials, we're certainly seeing some pretty meaningful raw material benefits, Frank. If you remember last year, we had a tremendous spike upward in VAM and PVOH prices that created a pretty significant headwind for the -- interlayer's part of that business. Those prices have now collapsed and dropped in price pretty significantly versus last year, and that's seen translated into a tailwind for us to recover our margins there.

PX has not been as much of a tailwind. Those prices have been holding up relative to last year. There's been a bunch of outages in that industry, new plants having trouble starting up, alternative fuel value, all those typical explanations with PX. So not as much of a tailwind there, but we're still well over $100 million of spread tailwind in that segment for the year.

And I think that is obviously helping with some of the demand challenges and building us into a very good margin position as we go into next year when mix comes back and how that flows through -- how that -- those margins will flow through to the bottom line in our fixed cost leverage.

In AFP, again, we've got good raw material tailwinds in that business as well. But the spread improvement is not as significant because we really have a lot of cost pass-through contracts, especially in the amines business. So we had very stable margins last year. That means they're also going to be stable this year by the nature of those contracts.

But those spreads are also coming in relatively good when you think about ammonia, methanol and some of the olefin-related propane, ethane type products going into the specialty. So overall, spreads are better there as well as -- on a full year basis, helping this year and will, of course, build momentum as volume comes back with better margin as we go into next year.

Operator

We now turn to Aleksey Yefremov with KeyCorp.

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

You discussed lower conversions of MoUs to definitive agreements in France. Can you just elaborate on that? Is it just for France or is it related to your second in the U.S. as well? And is this really related to demand uncertainty or price volatility in the plastics markets? What's happening there?

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

I just want to -- you broke up a little bit, Aleksey, I just want to make sure I understood the question. You're asking what's happening with the pace of contracting in France, given the current market conditions? Was that the question?

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

Yes, it was. Apologies. You're talking about MoU conversions to definitive agreements. Could you just elaborate on what's going on there?

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

Yes, sure. So first of all, the commitment and desire to get recycled content and products remains very strong. So when you look at the specialty businesses we're in right now from our Kingsport plant, the demand commitment, which is global, not just in North America but across the world for products and durables, cosmetics, packaging, for recycled content, remains very strong. We've got 70% of our potential output, where customers are very committed, as you saw in the prepared remarks.

When it comes to these PET or textile contracts that are the long-term sort of take-or-pay kind of structures for those markets, like the Pepsi contract. We are having great engagement and good discussions with a number of companies about those contracts. Like Pepsi, it takes a long time to negotiate these. They're very complicated contracts. And the current market conditions, I would say, are sort of slowing those discussions down a little bit.

So if you're looking at the PET market, whether it's vPET or rPET, those market prices have come off in a pretty significant way, which is purely just the story of everything else in the current macro, right? Demand is off in beverages, people are downscaling to sort of cheaper water bottles that have less material. A lot of that rPET also goes into carpet and textiles, where demand is down 20% to 30%. So that's just a temporary thing.

The key thing to keep in mind in these contracts is we are targeting applications within these brands where mechanical recycling doesn't really work. So if they want recycled content in those applications, they're going to have to use chemical recycling because the performance requirements and a variety of different technical aspects, the mechanical is just not going to actually work.

And I'm not going to get into details of that because I think that's a competitive advantage for us, given our deep polyester expertise relative to other companies out there, but that's definitely a key part of how we're going to win.

The second part is the degradation of polymer is already becoming clear in some markets, that you can't mechanically get to 100% recycled content. So while regulatory requirements may be only 25% in 2025, a lot of brands have set targets for some key applications to be 100% recycled content. And to maintain quality, they're not going to be able to do that with mechanical.

So we feel very confident that these contracts will get resolved, and we're going to get them in place. The engagement is high. And the regulatory requirements, especially in Europe, are going to require people to have recycled content.

And when you look at the market situation there, right now only about 12.5% of PET is sort of recycled. Mechanical industry does not have the ability to double that capacity between now and 2025 when that number needs to be 25% recycled content or you can't put the packages on the shelf. So we feel like we're in a good position, and working really productively with our customers. And we're aiming to have those contracts done by the end of the year.

Operator

Our next question comes from Mike Sison with Wells Fargo.

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

I was thinking about Advanced Materials a little bit. It feels like this year, obviously, maybe hopefully, trough adjusted EBIT. Now the sustainable day you had a couple of years ago, you had pointed to adjusted EBIT for the segment maybe closer to $700 million. Do you still think that that's the longer-term upside? And how do you bridge sort of the gap between the two to sort of get there from these levels?

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

Sure, Mike. And yes, we still think that's the destination for this business. Obviously, it's been a pretty volatile time over the last few years, from the pandemic to supply chain crisis to a recession.

And as I said a bit earlier, the extremity of what's happened in this switch from a COVID life to an experiences live and the impact of inflation, interest costs and how people can afford to spend on goods when they're just trying to afford everyday life and maximize their experiences at very high prices when it comes to hotels and everything else, has created a short-term constraint in how people can afford goods.

And consumer durables, as an example, is one of the places that is most discretionary, especially after they bought a lot during COVID. So demands are way below anything normal in consumer durables, and then you've got this huge amount of destocking on top of it on a very high-value mix product.

So as that market stabilizes, you'll see some recovery coming in the back half of the year, especially if you back out the inventory utilization headwinds. And we'll build good momentum into next year from an underlying market point of view.

And then you add on top of that recycled content, allowing us to add additional incremental value and substantial new volume from those applications. As we said, just getting started, it's a $75 million adder to next year in EPS for the Advanced Materials segment. So that obviously is going to be significantly helpful. The fixed cost leverage in this business, as we've demonstrated in the last 10 years, is significant, right?

This world is always growing double digits for us, and the underlying markets are typically growing 3% because we win so many applications because of better value proposition just because of product performance and product safety. And now you're adding on recycled content to further accelerate that curve.

The problem is, in a market like this, there's not a lot of new product launches, right? But we're continuing to win new business. Even now, that's going to help volume in the back half of the year on top of just waiting for destocking, we've won a lot of applications. But they'll really ramp up next year when things stabilize and they start launching new products. So all that sort of brings in better value from that side.

And then, of course, the last couple of years, the inflation has been really high. We've been trying to keep up with it. But now we're finally recovering our margins in this space. So you've got better margins on top of this volume recovery to sort of lever you to better earnings. So as you go through '24, '25, driving towards that $700 million is very much what we expect to do.

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

Got it. And just a quick follow-up for just kind of overall volume growth in '24, which I know is long way from here. But when you look at your customers' inventory, do you think they will need to restock? And if that's the case, when do you think a restocking event would occur? And if not, is it possible you just sort of plug along low single digit or some volume growth in '24, '25, '26, and maybe they don't need to replenish?

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

Well, first of all, I think what happened from April to now, the whole industry, from us all the way down to retailers, have gone to group think that it's going to be bad for the rest of the year, right? And everyone is acting under that assumption and pulling inventory down, managing in that context.

But there's a limit to how much destocking can occur. At some point, warehouses go empty, right? And in some of these markets, especially like durables, it's been emptied out for a long time, where automotive, there's a huge amount of pent-up demand because we're talking about demand being better this year, but it's from a really bad level last year, right?

So there's still plenty of pent-up demand there, and there's going to be plenty of pent-up demand in building construction with the dynamics of what's going on this year, constraining both demand and production of homes. There's a lot of upside across the whole corporation, when you think about it from both a demand point of view.

And you got to remember these destocking levels are huge, right? So destocking is 2 or 3x more than the underlying demand. And if that goes away, that's all volume recovery at some point, even if the underlying market demand doesn't improve.

And then to your question around inventory, I think it's -- with the actions that we're taking and everyone else is taking, you can see people driving inventories at very low levels. It's more likely than not that they're going to go below what they -- in an improving demand environment. And so there will be some amount of restocking.

Now our back half, just to be clear, has no restocking assumed in the guide that we gave you. So if that happens, that's upside. But if you look at '24 and say destocking has got to run its course eventually, so that you don't have that as a headwind for next year, and then some -- just a little bit of restocking just to get to levels to serve that demand, I think you can get a much better picture of volume next year than this year.

Operator

Our next question comes from David Begleiter with Deutsche Bank.

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

Mark, thanks for the update in Kingsport. On the project, do you have any forecast for estimated losses this year as you ramp up? And do you have an updated cost of the Kingsport project?

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

Thanks, David. First, I'd just highlight that the operating costs are going to be approximately neutral on a year-over-year basis. If you think about the preproduction that we're incurring this year, as well as the start-up expenses and also as we're using our bridge technology with glycolysis to seed the market, that's at a higher cost to bridge.

So on a year-over-year basis, the way I think about this is revenue growth is actually accretive to EBITDA. And as we outlined within our guidance on the $75 million of EBITDA on a year-over-year basis, roughly $50 million of that will be in Advanced Materials and the absence of the preproduction and start-up costs in our corporate other. So as I see it, that's roughly where we're getting the $75 million.

Also, if I think about our CapEx this year, we started the year at roughly $700 million to $800 million for the project. We took that up to $800 million. You can think about the combination of that and how we're managing our overall CapEx as the increases end of the project this year for the Kingsport project.

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

I apologize. I meant to ask what was the updated capital cost for the project itself and that total company CapEx.

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

Yes. I don't think at this time we're giving the capital cost for the Kingsport project. So we're not going to provide that at this time, David.

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

Understood. And just, Mark, just on Fibers and tow, do the contracts for next year have price increases embedded in them?

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

They don't have price increases embedded in them for next year versus this year, David, if that's your question. Obviously, prices have gone up considerably from last year. But the idea of these contracts is to prove our margins and profitability to a level where we can continue to reinvest in this business to be a reliable supplier to our customers. And we've achieved that type of pricing with our customers in these contracts. We've also put formulas in them to adjust for changes in energy cost to give stability for us and for our customers, which we have not had in the past.

So we feel great about what we've achieved in improving our sort of ability to support our customers and our current profitability. And these contracts are now in place, where about 75% is fully contracted now through next -- '24. Many of those are multiyear contracts. Hopefully, by the end of the year, we'll have that number up to 90%.

So great improvement in this business from its performance last year, and we're very focused on stabilizing it on the tow side to provide very attractive cash flow to support our growth investments across the company.

I would also note the textile business continues to do great on top of that, where, even in a 20% downmarket that we have this year in textiles, we're growing that business. So we're winning a lot of market share versus other materials because the value proposition of Naia is very compelling. It's a great beginning of life story, being based on biocontent and recycled plastic.

And importantly, and a bigger issue, going forward, now is microplastics, which are the fibers breaking up and getting into the ocean. And our fibers are fully certified to biodegrade when they do end up in the environment. And so that's a very significant positive, as the world is becoming more concerned about that as well. So it's just a great business.

Operator

Our next question comes from John Roberts with Credit Suisse.

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

On the second U.S. PET project, are you going more slowly on that?

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

We're nothing more slowly in any significant way, John. I mean right now, what we're doing is really focusing -- we haven't made a site announcement, so you could ask that question, too, because we're really looking at the incentives across several states. We've got 3 sites that are all very attractive, and the engineering work is continuing for whichever site we pick. And so we're just trying to get those incentives in place.

We feel great about our partnership with Pepsi as a significant baseload customer in that project, and we are sort of moving forward with that project to make sure we can serve the needs and put that together with the French project in Kingsport to get that $450 million EBITDA value for our owners, which is a great return on the capital required across those 3 projects.

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

And then on the Fibers business, assuming raw materials are sequentially stable, is all of the earnings step-down in the third quarter? Just remind us of the frequency of the reset on the price versus cost.

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

The contracts are quarterly. So a little bit of a step-down from Q2 to Q3 is just the prices adjusting for a lower energy environment.

Operator

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

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

Yes. Mark, with regard to Advanced Materials, do you have a sense today as to whether your third quarter earnings are likely to be flat, up or down sequentially versus the $99 million that you posted in the second quarter?

The reason I ask is reading the prepared remarks last night, it looks like you have a $40 million inventory-related hit in the third quarter, but you also say the second half should be better than the first half. So it seems like there's some countervailing trends there. So any comments on the seasonal cadence would be helpful.

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

So Kevin, I think we highlighted earlier that most of the $40 million headwind on the utilization rate will be in Q3. So as a result, I would expect it to be similar and slightly down sequentially in Advanced Materials.

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

Slightly down versus 2Q, Willie?

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

Correct.

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

Yes, of course, there the lack of that sequentially from Q3 to Q4, where that improving volume and spread will pop back up. So you can't think of normal seasonality around the back half of the year really for either AM or AFP because most of the inventory reduction actions are happening in Q3 more -- much more so than Q4.

But the volume momentum and margin improvement is continuing through 3Q and into 4Q, not just because of our inventory actions but because our customers are doing the same thing, right? They're also taking inventory down more in Q3 and oddly less in Q4, when you think about it, in the sort of odd year we're living in right now?

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

Yes, it is odd, isn't it? That's very helpful. Secondly, I wanted to ask about A&FP. I think you referenced a heat transfer fluid project that cost $15 million to be pulled into the second quarter. Can you just elaborate on what you're doing there and how that is translating to a meaningful earnings swing?

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

Yes, sure. So the fluids business is a bit sort of chunky in how volume shows up, right, because you have these very large projects. And at some point, they complete the project. And at the end of the completion, they need to charge that plant with heat transfer fluid to then start up the plant.

And in this case, this was an extremely large LNG project that had been under construction for several years, and their completion actually happened a little bit sooner than they expected and moved forward with wanting to charge that system, and so we shipped that volume. We thought it was going to be in the third quarter, turned out to be in the second quarter.

But this overall business is a great business. And something, I'd say, that we've really accomplished a lot in this business is diversifying our market exposure to different end markets. So historically, it's been very driven by the polyester industry and a few other sort of chemical facilities that use a lot of heat transfer fluid.

But we've seen a huge growth in LNG, as you know well with the geopolitical dynamics going on right now with Ukraine in Europe, and there's a lot of heat transfer fluid in those plants, too.

So we're diversifying out of China into other applications, like this project that creates a lot of value for this business. And they're very high-value projects. So when they do show up, they drop a lot of earnings to the bottom line. And so it just happened to be in Q2, which then means as you go sequentially from Q2 to Q3, you get a $30 million swing in earnings.

Operator

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

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

Talking a little bit about Naia in textiles, what's the opportunity for EBIT if we think about next year in growth? I mean I'm just thinking, given the margin recovery in cigarette filter tow, does it even make sense to rotate tonnage from filters to fibers? And is Naia still growing into your excess capacity? Or are you now transitioning filter capacity to textiles?

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

So first of all, Naia is a great business, the margins are very good. Obviously, recent improvements until margins are better. But the reality is, while we're really excited about the improvement in the tow business, it is a stable business that's still going to decline in volume about 1% a year. It's not a growth business.

So we continue to be very focused on serving our customers. These heat-not-burn products are certainly growing at 15% and [need] more filter tow, but that's just offsetting some underlying natural decline of cigarettes to get you to that sort of net 1% decline.

So we're not conflicted, capacity-wise, between this and growing our Naia business. But we are getting to the point where we are going to start using up the available capacity, and we're looking at capacity expansion options to continue to support the growth, right? Because our goal here with cellulosics is not to optimize the stream but to turn it into a growth stream, right?

Our goal here is to win in a variety of applications. So like polyester being a very high-growth stream for environmental reasons and providing sustainable products, our strategy, as we laid out Innovation Day, is to get $200 million of EBITDA growth of the stream on top of the tow business, right?

So when we talked to you in 2021, we weren't including improvements in tow, right? Tow is a new base, and we're still aiming to grow $200 million EBITDA on top of that new base. That's a very significant change from where we were in 2021.

We've got growth in Naia, which we're really excited about, as I explained the value proposition a moment ago. We have great growth prospects and some early wins in Aventa, this is our foamed cellulosic that can replace polystyrene in packaging. Clearly, polystyrene is being banned in many places for packaging, whether it's food packaging, in sort of protein trays for meat or the clamshells, et cetera.

And we've validated that our Aventa product will biodegrade both in not just industrial, but in residential composting, which is sort of the equivalent of landfill. So it really is a true end-of-life solution. So customers are super interested in that, huge market, lots of volume growth opportunity there.

Then you got micro beads, which is a super high-value opportunity in cosmetics. We've got success in recycled content in the ophthalmics business with how we're recycling the eyewear back into the product. So there's a lot of growth going on across the cellulosic stream. And so we're going to be looking at incremental capacity expansion to support all these growth opportunities as we move forward.

Fortunately, we have a very large and solid asset base. So it's not like building methanolysis plants. We can really leverage the capability we have here, but there'll still be capacity we're adding for Naia and all these other products between flake and fiber.

Operator

Our next question comes from Patrick Cunningham with Citigroup.

Patrick David Cunningham - *Citigroup Inc., Research Division - Research Analyst*

I know you have no expectations for any sort of restocking embedded in the full-year guide. But which end markets do you think are potentially best set up for restocking, whether it be in 4Q or into 2024? And how should we think about this in the context of upside to earnings from the specialty businesses?

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

Well, I think that it doesn't matter what end market we're in right now, there's a lot of destocking going on as everyone focuses on generating cash. And so I think there's probably opportunities for restocking pretty much across the markets. Building construction might be the one exception, where I think there's a lot of destocking still to be done from what we've seen from our customers in that space.

But everywhere else, I think there's some degree. And then it just gets into proportions, right? So where the destocking numbers are bigger, like consumer durables, then the potential for restocking is higher.

In more stable markets like personal care and water treatment and medical, I think the restocking opportunities are still there, but muted because they're just not doing as much. As far as earnings opportunity for next year, relative to this year, we're not going to sort of get into that yet. It's a little bit early.

Patrick David Cunningham - *Citigroup Inc., Research Division - Research Analyst*

Yes. That makes sense. And what's driving strength in acetic anhydride? And I think you referenced overall resilience in acetyls. I would have expected some weakness, given declining spreads in some of your end market commentary.

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

Well, for acetic anhydride, it goes more into food, pharma, feed type applications that -- where the demand is actually really stable. So it's not -- acetic acid goes into polyester where demand is down a lot in textiles. VAM goes into coatings and a bunch of other more economically sensitive applications.

When you think about different acetyl derivatives, acetic anhydride just has much more stable end markets. And large customers that place a lot of value on security of supply of that product for those kind of applications, so they tend to be more focused on supply than just what's the best price. So that just allows that business to be relatively stable.

I mean we're still -- we have some price pressure there. but it's not nearly as much as some of these other sort of derivatives or non-olefins, which is the bigger part of our portfolio, where the price pressure and spread compression is occurring in CI is really more of an olefin and plasticizer story.

Operator

(Operator Instructions) We now turn to Laurence Alexander with Jefferies.

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

I guess just two quick ones. As you think about the dynamics around inventories and fixed cost absorption, should incremental margins next year be above 60%? Or do you think some of the inventory reduction efforts you're doing now will spill over into Q1?

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

Laurence, this is Willie. To your point, I think we've demonstrated through various environments, one, that we can deliver strong cash flow, and that's what we're focused on doing now. As we think about the fixed cost utilization, I don't expect any spillovers into 2024. The actions that we're taking will be complete this year.

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Also on the incrementals, I think you've seen the decrementals that we're talking about. The incrementals will be equally positive. And I would add on to that, to your point, to get to the levels that you're talking about, that includes the mix upgrade and the high-value products as we think about our Advanced Materials and the more specialty nature there.

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

And secondly, kind of now that your peers are facing kind of more pressure on -- from the credit cycle, you always seem to have a sweet spot in M&A around finding people who are underinvesting in the engineering. Has your M&A pipeline changed? Or can you characterize kind of how actively you're looking at opportunities?

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

Yes. We're more focused on the bolt-on pipeline. We did a great bolt-on earlier this year in our performance films business. We're right now focused on our organic growth strategy with our investment in the 3 circular platforms.

We are looking -- our pipeline is mostly focused in smaller bolt-ons in Advanced Materials and Additives & Functional Products. And we're going to be disciplined with that strategy and stay focused on executing and in executing it well.

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

Yes. The recent acquisition we did of a manufacturing site in China is a great example. Performance films business has been performing incredibly well in this auto market last year, in this auto market this year. It's a very high-margin business. And that acquisition allows us to be domestically based on how we support customers in China, which is definitely where the China government wants to go is things made in China.

And those are great tuck-in acquisitions. Very highly accretive. Those are the kind of things we're focused on right now because our real priority is growing our dividend and creating this sort of organic-driven growth story around being a leader in the circular economy, both polyester and cellulosic.

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

And then just lastly, can you characterize or give a little bit more detail on what you think is going on with the agriculture chain inventories? I guess the timing and the severity of the adjustments seemed to have caught a lot of the industry a little bit flat-footed. So just curious about what you're hearing in terms of when people think it will end because I think you have a comment in the remarks about it accelerating into Christmas?

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

So I wouldn't say it's accelerating in the Christmas necessarily. So -- but what happened, I think, is pretty well discussed out there. Two things really.

Last year, with all the Ukraine events around ammonia and other uncertainties around supply chain, farmers around the world were stocking up on safety stock. And their warehouses, the retailers were stocking up on safety stock. Their distributors were stocking on safety stock. All the way back to the big players that make the products like Syngenta, Corteva, et cetera.

And so demand was really good. That was true through the first quarter. And as this chain started looking at season that wasn't going to quite need quite as much product because of the dry weather and not meeting it as much, and feeling like supply chains were now safe to rely on, sort of in the middle of Q2 kicked in significant destocking downstream of us.

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So we started to feel some of that destocking from our direct customers in the second quarter. And it ramped up to full destocking as we go into the third quarter and, to some degree, in the fourth quarter.

There's a lot of debate going on, I'd say, about just when does that destocking end and when they have to start ramping up on production to meet the growing season next year. It's important to realize that the final in-demand for the farmers is good this year and expect it to be good next year.

So this really is a whole inventory management cycle we're in. And at some point, they'll have to kick back into gear to make sure they have enough supply for next year, whether that's in the fourth quarter or the first -- the beginning of the first quarter, it has to happen sometime around then or they won't have enough inventory for the next growing season.

Operator

Our next question comes from Arun Viswanathan with RBC Capital Markets.

Arun Shankar Viswanathan - *RBC Capital Markets, Research Division - Senior Equity Analyst*

I guess I just wanted to go to AM and AFP. There are some markets which you are seeing -- which we're seeing some strength in, notably maybe the aerospace side and maybe the food side. Is that what you're seeing as well? And some of those stronger markets, you'd expect that to persist through the second half? How would you comment on some of your stronger markets?

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

So when it comes to aviation, our view is the market was -- has really improved through the first half of the year and will stay strong in the back half of the year.

I wouldn't say it's not still going to grow relative to the first half of the year, but it will -- because it's been pretty strong, but it will stay that way. The airlines are obviously very confident about their demand, going forward. And we'll track with wherever their demand goes. Right now, that's their viewpoint, and we're using their view to build our forecast.

Arun Shankar Viswanathan - *RBC Capital Markets, Research Division - Senior Equity Analyst*

And then just as a quick follow-up. Some other markets are notably on the weaker side. You addressed some of the destocking that's going on in amines in the ag side. What are some of the other areas that maybe turned out worse than you expected? And you've addressed a couple on the call already, but if you were to reiterate some of the weaker areas, what would those be?

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

From a Q2 point of view, the end market-wise, I'd say -- from an end market growth point of view, I don't think much has changed in our view across all of our end markets. We haven't seen different end markets get worse or better. Auto is strong. Obviously, discretionary markets are under pressure.

The personal care, water treatment, those kind of markets, are off 3% to 5% as all those downstream customers of ours that you can see in the fast-moving goods and everything else, reporting that they're focusing on pricing discipline and as a result, having a little bit less volume.

I don't think anything that's changed really. It's been more of a -- it's all about inventory management. It's the entire story for some of the negative surprises like medical packaging and ag in the second quarter, and destocking dragging out into the back half of the year, right?

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I just think that the extremity of COVID and then the following stimulus and the supply chain crisis has just led to a lot more inventory being built throughout the world than I think any of us really understood. And it's taking, obviously, a lot longer to pull it down, especially when demand is soft to some degree in every market.

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

Okay. I believe that was our last question. So thanks very much for your interest in Eastman and for joining us this morning. I hope everybody has a great day.

Operator

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

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