Third Quarter 2020 Financial Results Conference Call Script

Company Participants

- Andy Myers, Director of Investor Relations
- Frank A. Bozich, President and Chief Executive Officer
- David Stasse, Executive Vice President and Chief Financial Officer

Other Participants

- Frank Mitsch
- David Begleiter
- Hassan Ahmed
- Matthew Blair
- Eric Petrie
- Angel Octavio Castillo Malpica

Presentation

Operator introduction:
Good morning ladies and gentlemen, and welcome to the Trinseo third quarter 2020 Financial Results Conference Call. We welcome the Trinseo management team, Frank Bozich, President & CEO, David Stasse, Executive Vice President & CFO, and Andy Myers, Director of Investor Relations.

Today's conference call will include brief remarks by the management team followed by a question and answer session. The company distributed its press release, along with its presentation slides, at close of market yesterday. These documents are posted on the Company's Investor Relations website and furnished on a Form 8-K filed with the Securities and Exchange Commission.

If anyone should require operator assistance during the call, please press *, then zero, on your telephone. I will now hand the call over to Andy Myers.

Andy Myers
Thank you, Julie, and good morning everyone. At this time, all participants are in a listen-only mode. After our brief remarks, instructions will follow to participate in the question and answer session.

Our disclosure rules and cautionary note on forward-looking statements are noted on slide 2. During this presentation, we may make certain forward-looking statements, including issuing guidance and describing our future expectations. We must caution you that actual results could differ materially from what is discussed, described or implied in these statements. Factors that could cause actual results to differ include, but are not limited to, risk factors set forth in Item 1A of our annual report on Form 10-K or in our other filings made with the Securities and Exchange Commission. The Company undertakes no obligation to update or revise its forward-looking statements.

Today's presentation includes certain non-GAAP measurements. A reconciliation of these measurements to corresponding GAAP measures is provided in our earnings release and in the appendix of our investor presentation. A replay of the conference call and transcript will be archived on the Company's Investor Relations website shortly following the conference call. The replay will be available until November 6th, 2021. Now, I would like to turn the call over to Frank Bozich.

Frank A. Bozich

Thanks Andy, and welcome to Trinseo's third quarter earnings call. As we noted in our pre-announcement, the positive demand recovery we observed toward the end of the second quarter gained momentum through the third quarter. This led to significant sequential quarterly volume improvement in many applications. In automotive, third quarter volume was only down 14% versus the prior year after a decline of 65% in the second quarter. In tires, third quarter volume was flat to prior year after being down 55% in the second quarter. Styrene margins in Europe continued to benefit from low cost benzene, which led to favorable margins versus the prior year in our Feedstocks segment. Healthy demand contributed to improved year-over-year margins in ABS and polycarbonate applications. And our Polystyrene segment recorded its highest earnings quarter since 2015 as strong demand, particularly in appliances, as well as commercial excellence actions led to higher margins.

The margin expansion across many of our segments, along with both short-term and structural cost reductions, led to an increase in year-over-year earnings. I am very proud of our employees for the speed that they adjusted to new conditions and their perseverance through the challenges we have faced over the last two quarters, and I want to thank them for their hard work, which positioned us for success as demand returned.

Before I review our outlook for the fourth quarter, I'd like to highlight some announcements and developments occurring in the company, including a change in segmentation beginning in the fourth quarter. As of October 1st, our Performance Plastics segment has been divided into two new reporting segments – Engineered Materials and Base Plastics.

The Base Plastics segment includes ABS, polycarbonate and compounds product lines. The compounds are predominantly PC/ABS serving the automotive market. This segment also serves applications in packaging, appliances, and building and construction.

The Engineered Materials segment creates tailor-made specialty compounds and is composed of two product lines – rigid compounds and soft plastic compounds. The rigid compounds are made up of compounds in PC, ABS, and PC/ABS, with specialization in consumer electronics and medical applications. The soft plastic compounds include thermo-plastic elastomers, or TPEs, which are used in a variety of applications including footwear, personal care, and automotive. These products and applications are a core focus for growth as they serve markets that offer higher margins, faster growth, and less earnings volatility.

We feel this new reporting of our Performance Plastics segment will be important in providing enhanced transparency to investors and is better aligned with how we now manage the businesses. The appendix of the earnings presentation provides our historical results, beginning in 2018, recast under this new segmentation which will be effective for the fourth quarter and the full year 2020 reporting.

During the first quarter earnings call, we announced that we had begun the consultation process with our German Works Council related to the possible closure of our styrene assets in Boehlen, Germany. After a thorough evaluation, we have made the decision to continue operating the plant. We recently completed the negotiation of new feedstocks supply agreements that will significantly improve the competitiveness of this plant and provide for greater operational flexibility.

Next, I am pleased to share a few notes on our sustainability progress, including the advancement of polystyrene circularity. Offering sustainable solutions and products is a critical mission of our company. To that end, we continue to make progress toward our goal of reaching full polystyrene circularity. In September, we announced that our partnership with German packaging manufacturer Fernholz has resulted in Form Fill Seal formulations with 40% recycled polystyrene. These formulations can be used in food

packaging applications in full compliance with food safety requirements and requires no capital investment by our customers since the same equipment can be used in their production.

We also recently announced a Joint Development Agreement with INEOS Styrolution, Agilyx, and Americas Styrenics to share data and accelerate the realization of circular polystyrene. Additionally, we are making progress on our joint plan with INEOS for a European polystyrene recycling plant in France, which remains on track to be operational in 2023. This plant represents a significant step forward toward the ultimate goal of full polystyrene circularity as it will support depolymerization of polystyrene back to original styrene monomer, which can then be used for numerous applications.

All these actions are important steps toward our sustainability goal to offer an average of 30% recycled content to customers for polystyrene packaging in Europe by 2025. Our joint venture, Americas Styrenics, is also targeting a similar goal of 25% recycled polystyrene in its products designed for food service and food packaging by 2030.

In other areas of sustainability, three of our European sites received Mass Balance certification from the International Sustainability & Carbon Certification System. This will allow us to track the total amount of sustainable input throughout the production cycle and ensure an appropriate allocation to the finished goods. This will apply to our polystyrene from the Tessenderlo, Belgium site, polycarbonate from our Stade, Germany site, and synthetic rubber from our Schkopau, Germany site.

Lastly, we reached definitive agreement with Tyre Recycling Solutions on a commercial collaboration and an equity investment in that company. This agreement will allow a pooling of R&D resources, aiding in our goal of developing new value-creating solutions for the manufacturing of tires that improves their environmental footprint and create a sustainable outlet for end-of-life tires.

We continue to make solid progress on numerous sustainability fronts and the achievements here benefit not only the overall global environment, but also the financial performance in many of our segments as products with recycled content command a significantly higher margin.

Moving to our views of the fourth quarter, through October we observed a similar demand pattern to what we saw in the third quarter. We have seen recovery continue in automotive, tire and medical applications in addition to continued demand strength in the applications of packaging, appliances and consumer electronics. We're cautiously optimistic that this trend will persist for the duration of the quarter. We expect margins in polystyrene and polycarbonate product lines to be similar to the third quarter due to the sustained higher demand, while styrene margins in Europe are expected to decline slightly as benzene prices increase.

Our cash and liquidity position, already a point of strength heading into the third quarter, has only improved through effective cost control actions, working capital management, including inventory control initiatives, and higher earnings. Nine months into the year, we have generated $128 million of cash from operations with Free Cash Flow of $67 million. This has added to the strength of our balance sheet as we had $503 million of cash at the quarter end, even after the repayment of the $100 million revolver draw, which is now untapped.

This puts us in an excellent position to utilize our strong balance sheet to provide value to our shareholders, including growing the business organically and inorganically in areas of lower cyclicality and higher margins.

We look forward to finishing the year with a solid financial performance in the fourth quarter, a strong position in cash and liquidity, and with exemplary EH&S performance.

And now, Julie, you may open the phone line for questions.

Questions and Answers

Operator
Thank you. At this time, if you'd like to ask a question, press star one on your telephone.

Your first question comes from the line of David Begleiter with Deutsche Bank. Please go ahead.

Q – David Begleiter
Thank you. Good morning. Frank, just on the Boehlen site, if you had new agreements in place last year when you lost money at that site, what would EBITDA been under these new more beneficial arrangements?

A – Frank A. Bozich
Yes, so David. We didn't have new agreements at that site last year. So this is the new agreements will go into place effective January of next year and we expect that the operating loss that we occurred in 2019 if the market conditions are similar in 2021, that we won't be making losses under those same market conditions under the benefits of the new contract.

Q – David Begleiter
That's very helpful. And just the new segmentation, the Engineered Materials. Are you expecting to grow this business through acquisitions, and if so, what types of targets do you see out there, what multiples right now? Thank you.

A – Frank A. Bozich
Yeah, so David, maybe just a broader word on the re-segmentation, we really are excited about Engineered Materials. We've demonstrated very good growth in that business over the past several years and we're very focused on it. And this reporting is more aligned with how we operate the company now. We think it's really important to provide some transparency to it because of the attractive markets that offer higher growth, higher margins and volatility and lower volatility.

As it relates to the opportunity for acquisitions, we see that there are some out there. We're watching those. We think in this environment there are attractive assets that could become available on we want to be ready if the opportunity arises.

Q – David Begleiter
Thank you very much.

Operator
And your next question comes from the line of Frank Mitsch with Fermium Research. Please go ahead.

Q – Frank Mitsch
Thank you. Good morning. And just a note, really appreciated that pre-announcement last month, it obviously avoided some confusion with respect to the tax etcetera. So really allowed us to get a better feel for the trends and obviously, how it finished up strong.

And you said October was strong, just curious about what sort of visibility do you have on your order books? I know you expected that some of the strength will continue, but how confident are you as we look out obviously, November, I assume that you have that, pretty well set up, but how do you order books look into December, and thereafter?

A – Frank A. Bozich
Yeah, so, thanks Frank. And so we -- it depends by segment, but we typically would have visibility one, one month in advance and some of our segments where, we have long term, better forward look in our orders and that's more, it's a geographic issue too where, we have better longer lead time orders in North America and Europe.

In Asia, we have more spot orders, but I would say in general, we have over a month forward visibility and we can track and get a very good sense for what the month will be early and each monthly, when the month starts.

Q – Frank Mitsch
Got you. Okay. Go ahead David.

A – David Stasse
Frank, this is Dave. Yeah, I'll add a couple of things I mean, with styrene, obviously, the bulk of the economics are known at the beginning of the quarter when the settlements happen. So, with the November settlements already happened and they look to be pretty healthy, as was October in the end of last quarter. So I think to answer your question, I think what we see in October and in the order book as far as we can is kind of more of the same as how we exit the third quarter.

Now just to add if I could one caveat to that, the COVID situation obviously is changing and it's something we're keeping an eye on very closely with respect to shut down in certain European countries. We've not seen any impact of that yet in our order book, but clearly something that were mindful of and have contingency plans in place if needed.

Q – Frank Mitsch
Gotcha. Helpful. And Frank, you mentioned the recycle plant in France, that you share a JV with INEOS on and you're expecting that to start up in 2023. How do we think about the capital costs from Trinseo for that facility?

A – Frank A. Bozich
Yeah, we envision that over time, it'll be about a $20 million investment. The one thing that I do want to point out and something I alluded to in the comments is this is really an opportunity for us to expand margins in this area. And maybe touching on what's happening in Europe next year, there's a $1,000 tax being implemented on plastics that don't contain, certain level of recycled content. Now, that for us as we grow the recycled content of products that go into packaging that obviously, we can capture a great portion of that $1,000 a ton by letting the end we customers avoid having to pay that tax. So it's a great margin expansion opportunity for us and again we're -- we see ourselves as a leader in that sustainable solution space.

Q – Frank Mitsch
Got it. Thank you.

Operator
And your next question comes from the line of Hassan Ahmed with Alembic Global. Please go ahead.

Q -- Hassan Ahmed
Good morning Frank and Dave.

A – Frank A. Bozich
Good morning.

Q – Hassan Ahmed
Question around styrene, would love to hear your thoughts as you look at the near-term and looking into 2021 of the supply side of the picture.

Have you seen any meaningful changes in terms of the influx of new capacity, particularly keeping in mind some of the ups and downs we've seen as a result of COVID and part and parcel with that, what you guys seeing in terms of inventory trends?

A – Frank A. Bozich
So maybe let me start with the sort of supply demand balance and then we'll talk about the inventory trends second. Earlier this year there was new capacity that came online in Asia and off the top of my head, I believe it was approximately 6% addition of global capacity. Now, those plants are running but at reduced operating rates. And they, that's how they started and they've run at those rates. Now, what's an interesting dynamic that we saw play out in Q3 is that because of the continued low fuel demand, globally, European economics for styrene have improved relative to the rest of the world. And so Europe doesn't attract as many imports and it's put a stop to a lot of imports from other regions.

The second thing that's occurred is that and, as we've talked about before, the lower operating rates of the POSM plants in Europe, has made Europe, a more balanced market. And so we've benefited from that. And the last thing I would point out is something we've been talking about for several years now is the status of the non-integrated Chinese producers. So in September, or in Q3, there were actually two plants that represented about 450 KMT of capacity that were shut and these plants were shut basically for economic reasons as well as their inability to source ethylene.

So this was a dynamic that we have been anticipating to happen and these were the first two examples of these higher cost non-integrated plants either being non financially viable or not able to source ethylene in an environment where you have very strong polyethylene demand and that's where there's much greater margin to sell ethylene. So it's a favorable dynamic and we continue to watch it.

A – David Stasse
Hassan, this is Dave. I'll answer your question on inventory. Inventories as reported last week, China inventories were 126 kts, which compares to a long-term average of about one hundred. So it's a little bit higher, but it's falling rapidly; over the last month it's fallen 30% and just last week alone it fell 18%.

So supply is extremely tight in China and the reason for that is because of the strong derivative demand that you will see in our earnings, obviously, in both polystyrene and ABS as well as others that produce those polymers in Asia. So I think you're going to continue to see that inventory number drop.

Q – Hassan Ahmed
It makes complete sense very clear. And, as a follow-up on raws, in the presentation you guys touched on plentiful availability of naphtha, in Europe in particular, leading to lower benzene costs. I mean, how do you see that trend sort of playing out, be it through the course of the fourth quarter, and as you look into 2021 as well?

A – Frank A. Bozich
So, the driver for that is low fuel demand or distillate demand and the shift of the refinery operations to produce more naphtha. So, until you see a recovery of global fuel demand, in particular kerosene or jet fuel, I believe and our view is that we continue to see a long market for naphtha in Europe. And, favorable economics for us relative to the rest of the world.

And so, our current view is that at least through 2021, and I've seen some forecast that go beyond into 2023, but before global fuel demand, especially kerosene demand recovers to 2019 levels.

Q – Hassan Ahmed
Very helpful. Thanks so much guys.

Operator
And your next question comes from the line of Eric Petrie with Citi. Please go ahead.

Q – Eric Petrie
Hi, good morning Frank.

A – Frank A. Bozich
Good morning, Eric.

Q – Eric Petrie
As you noted styrene inventories have declined in China and I think prices since September are up from $800 to over $1,100 per ton. So, how does that impact your margins in ABS, latex and rubber and how much of those contracts are index based?

A – Frank A. Bozich
So, that basically had no impact on our margins. Most of our sales are formula based with index pricing, raw materials passed through pricing. But I'll take the opportunity to point out that in our Performance Plastics area we saw significantly better margins in Q3, really as a result of great commercial excellence efforts. And I think it goes to show that we have a very interesting product line, and we can differentiate our products into certain applications. And we've done a great job in the past several quarters value-pricing those.

A – David Stasse
Eric, just to add on to that, as Frank mentioned, in latex and rubber, largely in North America, the vast majority of the sales have contractual pass-through agreements. However, our polystyrene in Asia, we have very little actually, latex is almost entirely sold on a spot basis. Polystyrene is not sold with pass-through agreements. So as Frank pointed out I think it's really the higher margin has been a function of more value-based selling into the appliance producers in Asia.

Q – Eric Petrie
Helpful, thank you. And for my follow-up question, you recently launched the policy go with recycled content up to 50% for auto interiors. How has that been adopted by auto OEMs and how do you price that product for value?

A – Frank A. Bozich
So, I would say it's not just auto but I'd say broadly in almost every one of our end markets. There is a very strong desire and demand for more circular products that contain post-consumer recycled material. So, that product as well as the others, we see a premium on price versus virgin material and in many applications and, not specific to the Pulse Echo product line, but we've even seen multiples of the margins with recycled content. And the reference I made before in packaging, the new tax that will come into place in 2021, if we offer our customer the ability to avoid having to pay $1,000 a ton of tax on a product, we can capture a great percentage of that value.

Q – Eric Petrie
Thank you.

Operator
And your next question comes from the line of Matthew Blair with TPH. Please go ahead.

Q – Matthew Blair
Hey, good morning, everyone. Frank, the first question on Performance Plastics, so EBITDA was up about 40% year-over-year when things like autos were still down. Could you talk about some of the factors that helped boost it. Looking at the appendix, it looks like the Base Plastics really generated most of those. And then could you also talk about whether this level of earnings in Performance Plastics is sustainable into Q4 '20 and into early 2021?

A – Frank A. Bozich
Yeah, the driver for the Base Plastics performance is really very strong demand, and I would say into the appliance market is one of the particular areas where we've seen very strong demand and that's a result of COVID driven appliance demand around the world. And so, we've had very good volume demand, but really this is a margin story and it's a story about, we do have a differentiated product line, even though they're Base Plastics. In certain applications, we offer our customers many processing advantages and our team has really done a great job value-pricing those. Now, I believe, from what we can see, those conditions will continue through Q4.

We don't see any change right now in the environment that would make me believe it won't continue into 2021. But, and again as Dave pointed out earlier, it's a volatile situation with COVID and we've seen new shutdowns in Europe etcetera.

So again, it's difficult to say whether there's a resurgence of COVID that could affect our earnings going forward or the order book.

A – David Stasse
Maybe I'll just add something to that Matthew, just very quickly. We did point out and I think this will be instructive for you guys as you're thinking about 2021 that the net impact of COVID on us for this year we expect to be about $55 million.

And it's actually a plus $15 million in the second half of the year. And that plus $15 million is largely in Polystyrene and Base Plastics business where we've seen some orders that were booked in Q2, some demand that was pushed out of the second quarter into the third quarter and maybe a little bit of margin lift from tightness in the market. So, I think you should think about that to answer your question about 2021.

Q – Matthew Blair
Sounds good. And then Dave do you have any rough Q4 estimates on items like working capital, net timing and tax?

A – David Stasse
Yes, as it relates to cash, I think we see working capital as pretty flat in the quarter. We would usually see or we've often seen in the past, a working capital inflow in December, as volumes kind of fall off.

And I'm not sure we're going to see that this year given the demand environment that we're in so. I think I'd call working capital as pretty much flat right now. Cash tax in the fourth quarter - probably about $5 million. There is a slide in the deck that gives the other kind of year-to-date updates on CapEx, cash interest, things like that, and just back out the year-to-date numbers.

Q – Matthew Blair
Great. Thank you.

Operator
And your next question comes from the line of Angel Castillo with Morgan Stanley. Please go ahead.

Q – Angel Castillo
Good morning gentlemen and thank you for the question. I just wanted to touch base again on your comments on 2021 and the impact of COVID in 2020. So that $55 million that you noted and as we think about kind of run-rate and the earnings potential of the business. Right now if we just kind of take the third quarter it would imply something like a $400 million EBITDA for the business on an annual basis. But if we kind of, just take that $55 million and add it to, like I guess a full year EBITDA for 2020 it comes out to $300 million. So maybe if you could just kind of conceptualize everything for us and think and let us know like how do you see the normalized earnings power of the business, not necessarily in 2021, but as things normalize and your volumes improve and with margins being as strong as they are, how do you think about that going forward?

A – Frank A. Bozich
Yeah, I think, if you look at the second half as Dave pointed out, we would have anticipated that there was approximately a $15 million positive lift from COVID-related factors. The other thing that we pointed out is there were some cost benefits that are non-recurring in the second half of the year related to subsidies that we got related to the incentive programs in Europe.

And then also cost related actions that we took that in a recovery environment would not recur, so we wouldn't hang on to those even though we do have some structural costs savings that we got. So, I think if you factor those things in, the second half would be representative of what we would hope a normalized forward view of the business, would be - absent those factors. Those would be the gives and goes now, as we pointed out, we're seeing a resurgence of shutdowns in Europe, and we're cautiously optimistic that we'll work through it and we won't see another impact like we saw in Q2.

But, I guess, maybe just the last comment on this, no matter what the environment is, we feel very, very confident in our portfolio and in our ability to manage through it because we saw very, very negative Q2 economic and order environment. We actually were positive EBITDA in that period excluding timing and we generated significant free cash flow. So again, I know we can manage through whatever market environment we see because of the portfolio and actions we're able to take quickly and so we'll see what happens. But that would be how I think about next year.

Q – Angel Castillo
That's very helpful. Thank you. And then on your Engineered Materials, thank you for providing that information. In terms of the performance of that business, there was a pretty big pick-up in EBITDA in 2019, whereas it looks like volumes and sales were maybe a little bit flatter year-over-year. How do you see the go-forward, annual growth of that business as we move to 2021 and beyond?

And if you could give us some more color as to maybe what drove that uplift and margins into 2019 and whether we can expect that kind of to continue.

A – Frank A. Bozich
So I think there's really two drivers for the growth. It's us winning new business platforms in medical and consumer electronics and winning it with recycled material or more sustainable solutions that we're able to price at more advantageous margins.

So even though the volume was relatively flat year-over-year, the awards in the business we're winning with more sustainable solutions offer enough opportunity for us to value price those and I think that's reflected in the performance. As it relates to growth rate, I think those end markets themselves are growing at much better than GDP rates. But what we would see is that this is our ability to win platforms through customer qualification and various submissions where we're developing a specific customer solution can be much greater than that. So we really like this business. We've done pretty well in it. And, we're excited to continue to invest in it.

Q – Angel Castillo
Very helpful. Thank you.

Operator
And there are no further questions for today. This concludes today's conference call. Thank you all for joining us. You may now disconnect.