



Dow Inc.

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Jeff Zekauskas: Hi, my name is Jeff Zekauskas, and I analyze chemicals for JP Morgan. Thank you for coming to our 2023 Industrials Conference and braving this nasty weather.

This morning it's my pleasure to introduce the management of Dow Chemical. Representing Dow is Jim Fitterling, who's CEO. Jim's been CEO of Dow since it's become a public company again, and managed its operations while it was part of Dow Dupont. I think Jim's been at Dow for 40 years.

Jim Fitterling: Close, 39.

Jeff: Sorry, rounding up.

He managed its key businesses back during the 2008-2009 recession, so he really has a tremendous amount of experience and understanding of Dow.

Also in the audience is Pankaj Gupta, who is the head of Dow's investor relations. The format today is a fireside chat. I think Jim will begin with a few opening remarks, and then we'll continue.

Jim: Good morning everyone, and thank you, Jeff, for inviting us and for having us here today. Before we get into Q&A, I just wanted to provide an update on our Decarbonize and Grow strategy, look at the near-term market trends, and also how we remain positioned to continue to grow in the current environment and deliver long-term shareholder value.

We have a diverse global portfolio that's well positioned to capitalize on attractive growth opportunities, including increasing demand for more sustainable and circular solutions.

We continue to advance our Decarbonize and Grow strategy, which we expect to grow underlying EBITDA by \$3 billion while reducing our scope 1 and 2 CO2 emissions by 30 percent by 2030, compared to 2005 levels.

As a reminder, our clear path to decarbonize our footprint and grow earnings is a phased site-by-site approach that both retrofits and replaces end of life assets with low or zero CO2 emission facilities, while also expanding our capacity. We continue to make solid progress on this plan.

We recently announced a joint development agreement with X-energy to install the first grid scale advanced nuclear reactor for an industrial site in North America under the Department of Energy's Advanced Reactor Demonstration Program.

The project will be located at a Dow site in the U.S. Gulf Coast, which we anticipate selecting and making public in the second quarter. This technology will be a key long-term pathway to providing Dow sites with safe, reliable low carbon power and steam.

We also achieved another milestone in our Alberta Path to Zero project by contracting Fluor to provide front end engineering and design, procurement, and construction management services. We continue to work with the Canadian government to confirm the incentives necessary for us to make a final investment decision by the end of this year.

When we complete our Alberta project, we will decarbonize 20 percent of our global ethylene capacity, grow our global polyethylene capacity by 15 percent, and that will triple the polymer capacity at our Alberta site. That will be the first site that will be entirely a net zero site.

In the near term, shown on slide three, we delivered last year on our higher return, faster payback, and lower risk growth investment commitments, which are collectively expected to generate \$2 billion in run-rate EBITDA by mid-decade.

Importantly, we'll do that while maintaining a disciplined and balanced approach to capital allocation, including returning 65 percent of operating net income to shareholders across the economic cycle.

On slide four, since our fourth quarter earnings in January, when we announced them, the overall macro backdrop has remained pretty dynamic with some mixed economic data. In the U.S., as you all know, consumer spending remains resilient. January retail sales grew 3 percent month over month, and consumer confidence improved from some historically low levels.

However, durable goods orders in January declined versus December, and while February manufacturing PMI improved slightly, it still remained below 50. So we're carefully watching the impacts of inflation, which remains elevated and could lead to continued pressure to maintain

these tighter monetary policies.

In Europe, while natural gas prices hit a recent low in mid-February due to the seasonally warmer winter, consumer demand and industrial activity in Europe remains pressured, with manufacturing PMI declining to 48.5 in February.

In China, we're encouraged by recent improvements in economic activity with the manufacturing PMI returning to expansionary levels in February, reaching 51.6. However, it's still early stages of the reopening, and we're continuing to monitor the pace of the recovery post the Lunar New Year.

These trends have resulted in really mixed, and I'd say balanced, impacts across the business. Lower global energy and U.S. feedstock costs, a warmer winter, and improved supply availability have improved our cost positions.

When you look at our operating rates in the most cost advantaged assets, those remain high, but low global demand levels are keeping our overall operating rates constrained as we maintain our focus on operational discipline and on cash flow generation.

Demand is resilient in agricultural, pharma, and energy end markets, which are further supported by our industrial solutions business and the alkoxylation facility in Europe that we started up in February.

Demand for consumer durables and building and construction end markets remained under pressure in the United States, Europe, and China.

Taken together, our outlook for the first quarter remains in line with the modeling considerations that we shared previously when we did our fourth quarter earnings call, and we will look forward to how this year progresses.

So far this year we expect the oil and gas spreads to increasingly support pricing and margin expansion, especially as the operating rates improve in line with demand. This is also enabled by our structurally advantaged feedstock positions along the U.S. Gulf Coast, Canada, Argentina, and the Middle East.

We're continuing to work to implement our \$1 billion in cost savings actions that we announced in January in response to current market conditions. These include actions to maintain our low cost to serve operating model, and also to maximize cash flow.

Turning to the last slide, slide four, we've taken significant actions since spin to generate consistent cash flow and strengthen our balance sheet, providing us with ample liquidity and financial flexibility to navigate the near term dynamics, while also delivering on our disciplined and balanced capital allocation priorities.

At the same time, we're advancing our Decarbonize and Grow strategy, which will further uplift our underlying earnings profile and expand our competitive advantages over the economic cycle. Our focus on cash flow generation, operational agility and financial discipline will enable us to continue to deliver value near term and long term for our shareholders.

With that, Jeff, I'll turn it over and we can do some question and answer.

Jeff: Good. Maybe the place to start, Jim, is commodity companies are difficult to manage, and to value, in that one year Dow will earn \$12 billion in EBITDA, another year 9, and another year it will be 6.

When you try to think about how incentives work inside of Dow Chemical, where you have so much variability from the external world; you can execute very well, you can lower costs very well, but you're not rewarded in your share price because of these external factors.

When you think about how you manage Dow, or how the board looks at Dow, how does it try to get the incentives for management and the employees in the right place?

Jim: We've had different formulas for that over time. I would say the one we've landed on right now is looking at EBITDA; EBIT, really. If you look at our incentives, are based on EBIT.

I look at EBIT and EBITDA both, but we've said that we're going to keep our investments at or below D&A so EBITDA and EBIT should move relatively similarly.

We look at EBIT, and we also look at cash flow. One of the reasons we do that is, at different points in the cycle, you have to manage them differently. Obviously, when you're in an expansionary environment like we were in in 2021, coming out of 2020 and the pandemic, we went into an environment where pent up demand was very strong, and of course, now we know that there was restocking going on.

At the time, there were some supply constraints, so that combination led to record earnings, and

we were still in that territory for the first half of 2022. Then you come off the back of that and de-stocking starts to occur, inflation's coming in, and that's pushing pressure on demand. Energy prices had gone high again, especially in Europe, and Europe was a big impact.

If you look at the two, the thing that's been consistent is our management of cash flow over that cycle. EBITDA can be pretty variable, but we do a lot of modeling to project where we think we're going to be.

It forces you to continue to look at your asset footprint regularly, what assets are making money, what assets are competitive, which ones aren't going to be, and what decisions do you have to make.

Then the only other thing that we've factored into that long-term is obviously watching the balance sheet. We've spent a lot of time trying to get the balance sheet healthy so that when you get into a down cycle, you can afford to make the investments at the right time.

You've followed us for a number of years. We've had cases where we've been in a down cycle and didn't have the balance sheet or the cash to make the investments we need to make.

I think we're in a really good position right now. We've removed \$11 billion of debt from the balance sheet. Our leverage ratios are the lowest they've been at this point in the cycle, and our credit metrics are very, very good.

We're in a good position to make these Decarbonize and Grow investments, as well as our near term, faster payback investments, and use the strength of that balance sheet as we go through the cycle.

We don't have any near-term debt maturities until 2027. All of our debt is underpinned by bonds, so our interest rates are fixed. From a financial standpoint, I feel like at least our goal...When we were in 2020, looking at COVID and the impacts, our internal stated goal was, "We want to come out of this with the best balance sheet in the industry."

We felt like that would put us in a position to lead on the way out, and to be ahead of our competition, and of course, then our projects have executed well.

We have a lot of internal metrics around reliability and asset utilization, which are obviously critically important cost position or the footprint, but the two that are the top are EBITDA and cash

flow.

If you look at how we've spent the cash, we have reinvested in the business. We are ramping up to D&A, which we'll get to as we get into Decarbonize and Grow. We've retired shares, which we needed to do after spin. Our target at the end of this year is to have the share count down to 710 million shares, make sure that we can cover dilution.

Then opportunistically, if we have available cash, we can continue to take advantage of the cycle that we're in and the prices on the stock that we're in.

Jeff: Maybe if I could just try it a different way. You're correct in saying that Dow's balance sheet is so much better than it's been in the past. You've delevered \$11 billion.

At the same time, you've had a conservative acquisition strategy. That is, Dow is fundamentally a much stronger company, with much greater abilities to deploy capital if it chooses to do so. But at the same time, I think what you've said is that you want your CapEx to be at D&A or below.

So, is it the case, Jim, that you want to run Dow Chemical as a much less-levered entity over a longer period of time? Or, when you look out over a longer period of time, are there transformative opportunities that you see that you'll be able to take advantage of?

Jim: Obviously, we've done a lot of M&A in our history. I think we also have to keep an eye towards, will that be the value creating next step? We have a lot of organic growth investments in front of us, and we have a big challenge, obviously, to decarbonize the industry, which we think can be done, and contribute to bottom line earnings.

I think that's a win/win for investors. At the same time we decarbonize, we eliminate a lot of tail risk on the business. If we grow underlying earnings, we've really, I think, achieved the best result we can.

We've got pretty good market shares in many of the businesses that we're in, so this is an environment where, when you get into M&A with all of the pressures in Europe and the United States on looking at acquisitions and deals, sometimes the value you think you're going to create, and what you end up being able to transact, are very different. We've experienced that.

So I think we're going to be very prudent about looking at it. We're not saying we won't do any, but it has to be very compelling. Right now we haven't seen anything that compelling.

We still have some non-revenue generating assets on our balance sheet that we're continuing to look at. We took some terminal and rail operations here in the United States, and we put those out to market. We were able to achieve really good cost position for ongoing operations, as well as put those in the hands of infrastructure companies who achieve higher values for them, but also could grow on the back of that infrastructure, so we're continuing to look at that.

We have some really good assets both here and in Europe, which I think the market would value. That would allow us cash in to deploy against our growth opportunities.

Then I would say it would have to be a really, really compelling M&A opportunity, and one that we thought we could execute without having to lose a lot of value through the regulatory process, for us to be interested.

Jeff: One of the things that I've noticed is, when I compare Dow to Lyondell, for example, the dividend yields of both companies sit right on top of each other. Maybe they're a tenth of a percentage point different.

Sometimes, the enterprise value to EBITDA multiples of the two companies really can be sharply at variance, though the dividend yields are pretty tight. When you take a step back, Dow says over time it can increase its EBITDA by \$3 billion, and your dividend is \$2 billion. If the yield stake is constant and you double your dividend, then the share price should double.

But you're a commodity company, so when you think about dividend changes, there's always a cash flow dimension in whether one is strong enough, or whether one's not strong enough. Dow's dividend has been flat since you became a public company.

Do you have thoughts about the dividend longer term, or does the board have thoughts relative to the increasing EBITDA that you have and the stronger balance sheet you've got?

Jim: Sure. The reason we've kept the dividend flat over that time period is our first focus was on getting the balance sheet right.

We also leaned in on share buyback because we thought the shares were undervalued, so we took advantage of that lever to retire some shares and get that part correct.

The board, long term, wants to see us grow into a bigger dividend. They want to see us continue

to demonstrate that we can make the kinds of investments like we made in Texas and the U.S. Gulf Coast back in the last wave of investment, make these near-term investments, start to demonstrate the return on invested capital that your investors and our holders want to see. Then, over time be able to grow into that.

They know the history of Dow, which for many, many years was at, maintain a dividend or grow the dividend as you grew the company. That got interrupted back, really, post the Union Carbide acquisition 2001-02 timeframe, and then got hit again during the Rohm and Haas acquisition.

I think we're back to a strong dividend yield, kind of best in our industry, best balance sheet in the industry, good growth playbook for organic growth ahead of us.

Challenges, but I would say motivating challenges; decarbonizing may seem to investors like that's a non-sexy thing, but you have to reinvest in these assets over time. This is actually very motivating for the people that work at Dow.

We have no problem hiring people to come in to work in this environment, whether it's decarbonization or circularity. This is what young engineers want to work on. We've got enough examples that we think we can do this, and do it profitably, and it'll be another leg of growth for the business.

Jeff: Maybe one last question on Dow as a shareholder value creating entity, before we go into the businesses.

When I take a step back, I think, OK, Dow has a 5 percent dividend yield. Normally the S&P grows 7 percent on average, so in order for Dow to keep pace with the S&P, or grow faster than the S&P, it just shouldn't be that hard, because if you're collecting 5 percent on the dividend, you need 2 percent in the share price for total return.

You've got a big free cash flow yield. You've got investment opportunities. You can raise the dividend. When you talk to your shareholders, do they see it that way? What do they want from you?

Jim: Yeah, I think they increasingly have focused in on cash and the free cash flow yield, which is moving in the right direction.

Last year, I would say, a lot of the discussion was around retiring shares and the obvious

increase in EPS that that helps generate. But I think, longer term, you're right. They're interested in the growth of the business. Growth is important to us, but value growth is the most important thing for us.

We're moving into a very changing marketplace. You've got a lot of big external things that we're trying to deal with; U.S.-China relations, what's going on with Russia-Ukraine. These impact energy markets.

These impact big end markets, so I don't want to lead people to believe that just throwing more money into new investments means you're necessarily going to grow, or grow value. You have to put them in the right place. They have to be cost advantaged. They have to be near, or have good access to market.

And I think we've done that. Canada is a case in point, where it's a decarbonize investment, but it's a decarbonize investment that is a big step change in growth for us. It's also one of the lowest cost positions, from a feedstock cost, anywhere in the world, and it's maintained an advantage for decades.

It actually adds to our U.S. Gulf Coast footprint. We tripled the size of Canada. We've got Argentina. We've got the Middle East. This gives us a lot of flexibility. It continues to shift our focus towards light cracking, which in olefins, polyolefins, and all of our propylene derivatives, is a big value advantage for us.

Then it also gives us the kind of earnings that we come off of that project, now that you've got the IRA coming in the U.S., and you're starting to see policies put in place that are going to support the kinds of things we need to do to decarbonize here, for example, support for carbon capture and hydrogen.

That's going to create the environment where we should be able to come off of that project and then roll right into U.S. Gulf Coast. At that point, you start to really move to the tipping point of decarbonizing the portfolio.

Investments in the new technologies, I'd say, are extending your competitive advantage in your life at the sites. If you look at the sites, once you get this right, you've set yourself up for 30, 40 years of really good returns.

We have a long-term lens to that, but in the near term, I completely agree with you. We do think

the shares get undervalued, and we do think there's a natural sentiment in the marketplace that people more closely associate us with oil and gas, which they have a negative view of. I don't think that's very realistic.

If you look at the products that we make, they touch everything you use every day. They're an important part to growing middle class. They're an important part to solving world hunger through food packaging. They're an important part to making electric vehicles, making wind blades, solar panels.

The growth for those products is going to continue, and if you do it in the right way, I think you'll have not just a first mover advantage, but a long-term advantage for those people that buy your products.

Jeff: It's funny, Jim, if I knew nothing about Dow's decarbonization strategy and you said to me, "Well, where might Dow expand?" I'd say, "Oh, Western Canada," in that, there's very inexpensive ethane, you already have a footprint. And now, of course, you can take the carbon dioxide and you can put it in the trunk line.

In all, through Dow's history, that always would have been a very rational investment to make. Notwithstanding you having these steps toward decarbonization, it seems that those steps toward decarbonization are absolutely consistent with attempting to achieve a high return on capital over a longer period of time.

Jim: It is. If you look at the basic design, after every major investment, we try to make the next one better.

If you look at Texas 9, the investment that we put from the Gulf Coast and started up in 2017, that project, since it started up, has had a greater than 15 percent return on invested capital. That is unbelievable for a world scale cracker for that time period.

We built off of that. We actually think we can build the project in Alberta with a lower cost per ton, just using things that we learned, through construction techniques, efficiencies around the construction, our ability to execute good projects.

We've got the right policies in Canada on price on carbon. We've got the availability of the carbon trunk line; two things I think we will have in the United States as well, by the time we're ready to move into that phase.

And we've got a good low cost natural gas position. That's kind of win/win/win territory, so we look at it as a no regrets move. You can decarbonize and you can deliver equal or better than Texas 9 type of returns. That is really a lot more value creation, I would say right now, than an M&A deal.

So we've got to look at that and say, "How do we move off of that and then replicate quickly?" If we can do that along the way, we will probably have to build new world scale, and retire some old assets at the same time, which will give us a boost on decarbonizing.

But old assets also require a lot of maintenance, capital, and at some point you've got to just stop putting money into the old assets and move to the new technology.

Jeff: One way of thinking about Dow's durable profitability and EBITDA growth and free cash flow growth, is you benefit from the oil/gas spread. That is, there's expensive Brent, and in the United States, at least since 2009, we've had inexpensive natural gas and inexpensive ethane.

But when we look out over time, there's some people who think that there's growth in electric vehicles, and what that's going to do is limit oil demand. There are some people who think that, over time, the United States is going to export so much more of its natural gas and maybe more of its ethane, and it may be the case that natural gas prices in North America become more of a global price rather than a more protected market.

When Dow looks out over a 10- or a 20-year period...Now, I get it. Building more capacity in Saskatchewan is going to be fine under all these circumstances. But when you look at those kinds of factors, how does that enter into your long-term capital decisions, and the way that you manage your cash flows?

Jim: Well, it's a very timely topic because of the situation we're going through with Europe right now, obviously looking at the European industrial situation, and will it be competitive longer term?

It's a big market for most of us, and it's a place where we've had an asset footprint for a long time, but competitiveness has dramatically changed.

We have a natural and very, very strong competitive advantage in the U.S., in that we have low energy costs.

Low energy costs underpins everything. Manufacturing is going to rely more and more on

electricity costs because, in order to be able to make things here in the United States, it's going to have to be automated, and automation with machines means electricity. Automation for the tech industry means servers and reliability.

I know politics gets in the way of this, but that necessarily means there's going to be a tremendous need for more natural gas, long term. Both here, but also abroad.

Europe is going to need more because they certainly don't want to move back into coal fired electricity, and they've taken some positions on nuclear that don't make it very clear that they would move into nuclear space.

I think with what the U.S. is doing with both alternatives, advanced nuclear, if they come back and make some investments in their conventional technologies, we will continue to maintain that cost advantage position for manufacturing here.

That's going to be critical if we want to reshore the kinds of manufacturing jobs that we're talking about. I mean, reshore them to America, not Mexico, but bring them back here.

Natural gas exports, I have a strong opinion that if we export more natural gas, that'll be good for our industry. That typically means good competitive costs back here. The net back costs are usually the best here.

I think most countries that have ethane to make downstream materials, they try to keep it in-country, but I don't know that that's necessarily the biggest issue. I think it's natural gas production that will determine how much ethane you have available here.

I think we have an obligation. We need to rebuild our allies around the world. You have to remember that, say the developing world, if you don't want them to electrify their countries -- like India is doing right now, or like most of sub Saharan Africa will have to do.

If you don't want them to do that on coal, and most of them are probably not going to be able to do it on nuclear, you need to provide natural gas along with alternatives for them to have reliable grid power. Reliable grid power is going to be what enables their industries to grow.

We're already seeing challenges here with grid reliability, so I think we're getting the right kind of policy discussions finally, in D.C., around what's necessary to support conventional. I do think in the future, we may burn less oil and less natural gas, and we may convert more of it to materials.

Half of what we use today, we don't burn. It actually gets converted into the durable goods and the disposable goods that you use at home, and those markets will continue to grow. There's growth to take up that, but you can't not invest in those.

If you don't invest in them for a two or three year period of time, you get yourself behind the curve, which is what you've seen with oil. We don't invest for five years at a certain level, production declines. Then when you need the supply, and you start to invest, it's three to four to five years before the supply comes on, and during that time frame, you have very high oil prices.

We've got to get our mindset right. If we want grid reliability, we don't want blackouts and brownouts, we've got to focus on more natural gas production.

We've got to do what we're doing with the IRA, which is carbon capture and hydrogen and be agnostic to the color of hydrogen, which I think is an advantage in the US approach, vis a vis Europe. Europe has said we're going to place all of our bets on specific types of green hydrogen. I think that's going to back them into a corner again.

Then we've got to look at nuclear for baseload and nuclear and gas as the future baseload, I think is what allows the alternatives to continue to thrive as well.

Jeff: Well, thank you for that. I can't let you go without asking about the short term. In the fourth quarter of 2022, I think ethane prices were 38 or 39 cents a gallon. Maybe this quarter so far, they're 25 cents a gallon.

That's a six cent a pound benefit on integrated polyethylene margins, but the polyethylene market is a little murky now because there are contractual changes, and then they're off the table discounts, or maybe there are, maybe there aren't.

But when you look on a raw material basis, into the first quarter, it seems you're six cents to the good, but you have a more conservative posture toward earnings and specialty plastics. Can you describe exactly what's behind that?

Jim: Two things I think are important to remember. You've got ethylene margin, and then you've got margin above ethylene for polyethylene, so we look at integrated margin as kind of having two parts to it.

Obviously, on the ethylene side, you've seen things sequentially start to improve. We've seen, as I mentioned, operating rates in the U.S. continue to be high on ethylene, and you've seen the structural improvement in ethane costs. Oil has continued to be relatively strong, so those oil to gas absolute spreads have been there.

I'd say the thing that's different is on the demand side, on polyethylene, you've got new supply coming on in the near term. You've got some lower demand from destocking, some from destocking, some from durable goods reductions, so that's put pressure there.

While integrated margins are improving through the quarter, they're certainly a long way from where they were in first quarter last year. I think at the peak, we were above 40 cents integrated margins, and we're not near those levels right now, but we're improved a lot off of the December levels.

This is going to be one of those years where we'll build that margin, I think, gradually as we move through the year.

On the macro basis, the amount of new capacity that's coming on will take about a year to absorb, so I don't feel nervous about the ability for the market to absorb the new capacity, but instantaneously when it comes on, obviously you see some pressure from that.

We'll navigate through that. Most feeling is, if we're able to navigate inflation and the whole world does not go into a recession, I think you're looking at gradually improving through the year into a stronger year, next year.

At least that's our mindset and our outlook. But in the near term, it's really heavy lifting to try to continue to move that up.

Jeff: When you think about China over a longer period of time, do you see a diminution in its historical rates of growth, and do you think that that really will affect plastics supply demand balances over a longer period of time?

That is, do you think the long-term polyethylene growth rate...If I asked you that question a year or two ago, and now I ask you the question, do you think the growth rate is slower, or the same, or faster?

Jim: There are a lot of things that go into long term PE growth rate, but if you think about it, since

back in the '80s, we've done a lot of work to do more with less in plastics. A considerable amount of work to downgauge and make packaging with a lot less weight of material, and yet, the growth rates have still been 1.4 times GDP.

I think that's going to continue. I'd say the mix may be different. We're going to see more recycled material coming into the feedstock, and maybe less conventional. You'll still need some conventional material to make the quality that you need for food grade. In others, you're going to have to take recycled material and blend it with virgin material.

Or, much more investments in advanced recycling to take it back to a monomer state and make product out of it. But I think you'll see that happen.

China's continued to invest to grow mostly to support their own market. They've not been an exporter, but they've been there to support China.

China for China has been a strategy since the mid '90s, when they opened up. That's why the grab for as much intellectual property and technology as they can get to support their own industries.

But now I think they're going to have to shift towards, what's the return on those investments? The government has supported those investments, but the government now is going to need to see returns on those investments. I think that mindset has to come in.

Then the other thing that supported a lot of China's growth has been construction and housing. What we saw at the end of last year was housing and construction off 40 to 50 percent and, so far, not much stimulus going back into that space. I think that is because of the concerns on the returns on those investments.

China is going to change, but I think in a way it will change to the better if its focus is on value and not just shoring up its own domestic supply. It's getting to that point, where it's got enough domestic supply.

Jeff: Maybe the capacity that comes on in China over a longer period of time will be a little less.

Thank you very much for attending our discussion, Jim. Thank you so much. I hope you come back next year.

Jim: Thank you very much.



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