

Lanxess (LXSG.DE)

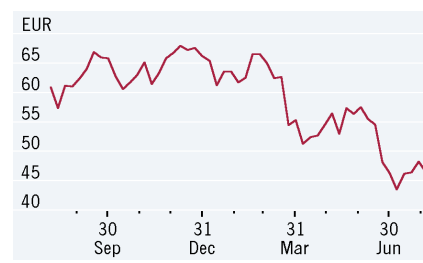
No Grip; Sell reiterated

- Estimate Change
- Target Price Change

- **Cutting estimates** — We cut our 2013E and 2014E adj. EPS by 37% and 17% respectively as 2H13 demand recovery seems elusive on the back of competitive pressures and plummeting butadiene prices (-34% QoQ). As a result we cut our TP to €37 from €40. We now assume FY13E adj. EBITDA of €746m, just below the mid-point of its guidance of €700-800m. Vara Consensus is at €813m. Given the lack of pricing power, loss of market share, stretched balance sheet and further downside risk to consensus estimates, we reiterate our Sell rating.
- **Losing market share and pricing power** — LXS confirmed it lost market share in Performance Polymers. In China, for instance, Japanese competitors seem to have taken advantage of the lower Yen taking share via lower prices. In order to regain some ground, LXS will need to stay highly competitive, which limits margin upside. For the 2nd quarter in a row, its selling prices fell by significantly more than the raw material decline. In addition, tyre customers seem to be down-trading, i.e. buying lower-quality rubber, according to LXS. This negative mix effect puts additional pressure on earnings.
- **Customer De-stocking – Really?** — LXS cautioned on hopes of any volume recovery despite more encouraging data coming out of the tyre industry as of late. According to management, customers, especially in Asia, still carry high levels of inventory (tyres, synthetic rubber) and continue to de-stock. However, looking at latest inventory data from Michelin, Pirelli and Goodyear, absolute inventory levels are almost unchanged vs. the previous quarter despite lower raw material costs. This suggests re-stocking rather than de-stocking. Hence, issues like loss of market share and increased competition seem more likely to have caused the current weakness.
- **Supply side response acknowledged** — For the first time, LXS acknowledged increased supply in the global synthetic rubber chain and confirmed that it created a more competitive environment in both high- and low-end products. As a reminder, we see global butadiene capacity to increase by 6-7% p.a. in the next two years and synthetic rubber supply by 10-15% p.a. depending on the grade. For more details please see [Lanxess \(LXSG.DE\) - 2013 – The Supply Side Responds; Sell](#)

Sell	3
Price (06 Aug 13)	€44.78
Target price	€37.00
	from €40.00
Expected share price return	-17.4%
Expected dividend yield	2.0%
Expected total return	-15.4%
Market Cap	€3,726M
	US\$4,940M

Price Performance (RIC: LXSG.DE, BB: LXS GR)



Lanxess (EUR)

Year to 31 Dec	2011A	2012A	2013E	2014E	2015E
Sales (€M)	8,775.0	9,094.0	8,235.9	8,769.6	9,364.3
Net Income (€M)	544.7	544.0	140.5	278.0	354.8
Diluted EPS (€)	6.55	6.54	1.69	3.34	4.26
Diluted EPS (Old) (€)	6.55	6.54	2.70	4.09	4.81
PE (x)	6.8	6.8	26.5	13.4	10.5
EV/EBITDA (x)	5.0	5.0	8.5	7.0	6.2
DPS (€)	0.85	1.00	1.00	1.05	1.10
Net Div Yield (%)	1.9	2.2	2.2	2.3	2.5

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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LXSG.DE: Fiscal year end 31-Dec						Price: €44.78; TP: €37.00; Market Cap: €3,726m; Recomm: Sell					
Profit & Loss (€m)	2011	2012	2013E	2014E	2015E	Valuation ratios	2011	2012	2013E	2014E	2015E
Sales revenue	8,775	9,094	8,236	8,770	9,364	PE (x)	6.8	6.8	26.5	13.4	10.5
Cost of sales	-6,765	-6,986	-6,327	-6,737	-7,194	PB (x)	1.8	1.6	1.6	1.5	1.4
Gross profit	2,010	2,108	1,909	2,033	2,171	EV/EBITDA (x)	5.0	5.0	8.5	7.0	6.2
Gross Margin (%)	22.9	23.2	23.2	23.2	23.2	FCF yield (%)	-0.1	3.8	-1.7	1.7	5.4
EBITDA (Adj)	1,146	1,227	746	932	1,055	Dividend yield (%)	1.9	2.2	2.2	2.3	2.5
EBITDA Margin (Adj) (%)	13.1	13.5	9.1	10.6	11.3	Payout ratio (%)	13	15	59	31	26
Depreciation	-320	-378	-424	-440	-472	ROE (%)	26.6	23.5	4.6	11.6	13.9
Amortisation	0	0	0	0	0	Cashflow (€m)					
EBIT (Adj)	826	849	322	492	583	EBITDA	1,146	1,227	746	932	1,055
EBIT Margin (Adj) (%)	9.4	9.3	3.9	5.6	6.2	Working capital	-256	-118	-52	-101	-113
Net interest	-93	-96	-100	-90	-80	Other	-216	-271	-156	-166	-192
Associates	7	1	0	0	0	Operating cashflow					
Non-op/Except	-85	-85	-81	-40	-41	Capex	-679	-696	-600	-600	-550
Pre-tax profit	655	669	141	363	462	Net acq/disposals	-244	22	0	0	0
Tax	-148	-154	-32	-83	-106	Other	0	0	0	0	0
Extraord./Min.Int./Pref.div.	-1	-1	-1	-1	-1	Investing cashflow					
Reported net profit	506	514	107	278	355	Dividends paid	-58	-72	-83	-83	-87
Net Margin (%)	5.8	5.7	1.3	3.2	3.8	Financing cashflow					
Core NPAT	545	544	141	278	355	Net change in cash	313	569	119	110	100
Per share data						Free cashflow to s/holders					
Reported EPS (€)	6.09	6.18	1.29	3.34	4.26		-5	142	-62	65	201
Core EPS (€)	6.55	6.54	1.69	3.34	4.26						
DPS (€)	0.85	1.00	1.00	1.05	1.10						
CFPS (€)	8.11	10.07	6.46	7.99	9.03						
FCFPS (€)	-0.06	1.71	-0.75	0.78	2.41						
BVPS (€)	24.75	27.82	28.20	29.61	31.85						
Wtd avg ord shares (m)	83.2	83.2	83.2	83.2	83.2						
Wtd avg diluted shares (m)	83.2	83.2	83.2	83.2	83.2						
Growth rates											
Sales revenue (%)	23.3	3.6	-9.4	6.5	6.8						
EBIT (Adj) (%)	30.1	2.8	-62.0	52.7	18.5						
Core NPAT (%)	36.0	-0.1	-74.2	97.8	27.6						
Core EPS (%)	36.0	-0.2	-74.2	97.8	27.6						
Balance Sheet (€m)											
Cash & cash equiv.	528	797	797	797	797						
Accounts receivables	1,146	1,527	1,314	1,371	1,435						
Inventory	1,386	1,117	1,315	1,400	1,495						
Net fixed & other tangibles	2,807	3,112	3,294	3,460	3,545						
Goodwill & intangibles	373	390	390	390	390						
Financial & other assets	638	576	562	594	629						
Total assets	6,878	7,519	7,672	8,013	8,291						
Accounts payable	921	968	877	933	997						
Short-term debt	633	167	432	560	547						
Long-term debt	1,465	2,167	2,167	2,167	2,167						
Provisions & other liab	1,785	1,886	1,836	1,873	1,914						
Total liabilities	4,804	5,188	5,312	5,534	5,625						
Shareholders' equity	2,058	2,315	2,346	2,464	2,650						
Minority interests	16	16	14	15	16						
Total equity	2,074	2,331	2,361	2,479	2,666						
Net debt	1,570	1,537	1,802	1,930	1,917						
Net debt to equity (%)	75.7	65.9	76.3	77.8	71.9						

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For definitions of the items in this table, please click [here](#).

From Leader to Follower

Key issues for us are:

- 1) Increasing supply across the synthetic rubber chain. LXS acknowledged this for the first time and noted increasing competition for product in the current lower-growth environment. This keeps pressure on margins.
- 2) Loss of market share. This has been confirmed by the company. It held on to selling prices for too long while Japanese competitors for instance took advantage of the lower Yen and started to cut prices more aggressively, especially in China.
- 3) Loss of pricing power. For a 2nd quarter in a row it had to pass on more than the raw material cost decline to its customers in order to regain some volumes.
- 4) Down-Trading. Customers have started to down-trade, resulting in negative mix effects, which puts additional pressure on margins.
- 5) Butadiene prices continued to collapse in July and August. So far the 3Q13 average price is down 34% QoQ in EU. This creates sequential downside risk to Performance Polymers EBITDA (see below).
- 6) Net debt was above €2bn at the end of 1H13. While we expect net debt to fall by c. €200m till YE13, net debt/EBITDA is likely to remain elevated at c. 2.4x.

Citi vs. Consensus

We cut our forecasts and our new adj. EBITDA puts us 8% and 14% below consensus respectively. We expect further consensus downgrades going forward.

Figure 1. CITI vs. Consensus

	2013E			2014E		
	Citi	Consensus	Deviation	Citi	Consensus	Deviation
Sales (€m)	8,236	8,519	-3.3%	8,770	9,165	-4.3%
EBITDA (€m)	746	812	-8.2%	932	1,088	-14.3%
Margin	9.1%	9.5%		10.6%	11.9%	
EPS(€) adj	1.69	2.37	-28.6%	3.34	4.79	-30.2%

Source: Powered by dataCentral.

Butadiene drives Performance Polymers

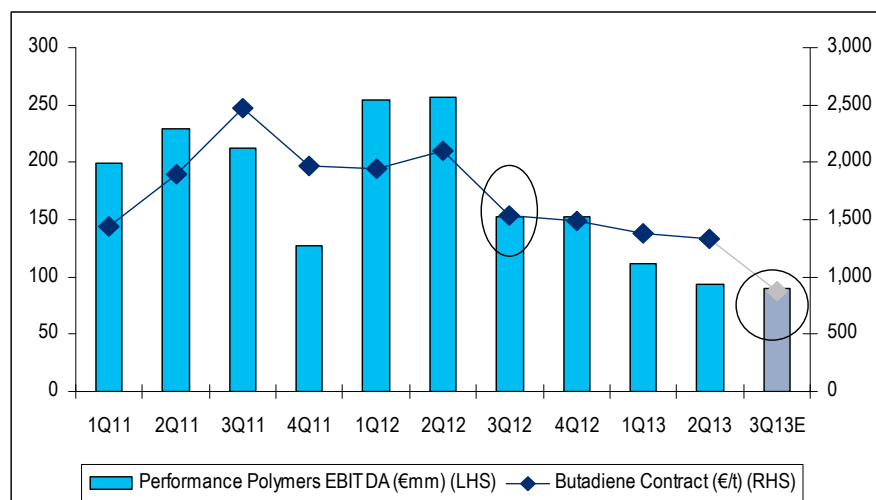
Expect underlying decline in Perf. Polymers EBITDA in 3Q13 due to slump in BD prices in EU

Butadiene (BD) prices driven Performance Polymers EBITDA. In 3Q13 EU BD prices have collapsed by 34% QoQ so far. As a result we expect Performance Polymers to report a sequential decline in underlying EBITDA in 3Q13.

Latest spot prices in Asia suggest some recovery in Butadiene prices as prices have fallen below cash cost level and producers started to shut down capacity in order to balance supply and demand. Hence, prices seem to have reached a bottom for now.

In EU, we expect prices to rebound by about €100/t in September to €850/t, followed by a further recovery to €900/t for the rest of the year. We therefore see FY13E Butadiene prices in EU down 37% YoY, which should result in a price decline for LXS of about 15-16% this year, according to our estimates.

Figure 2. Performance Polymers adj. EBITDA and EU Butadiene Contract Prices



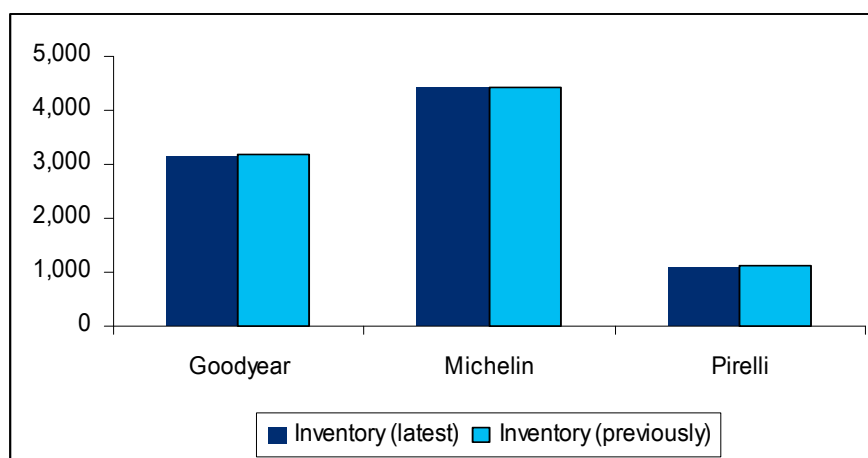
Source: Citi Research; ICIS; company reports

Stable QoQ inventory levels despite falling raw material costs suggests volume re-stocking rather than de-stocking

Stable Inventory levels at tyre makers

We looked at the latest inventory data from Michelin, Goodyear and Pirelli and compared it with the data from the previous quarter. On an absolute level, inventory remained fairly unchanged despite a decline in raw material costs. This suggests an increase in volumes and therefore re-stocking rather than de-stocking. Hence, while some producers might indeed have de-stocked, which would affect LXS, we think increased competition and loss of market share are most likely the main reasons behind the lack of volume recovery in LXS' order book rather than broad-based customer de-stocking.

Figure 3. Inventory in €m at Goodyear, Michelin and Pirelli – Latest vs. previous quarter



Source: Citi Research; company reports

Financials

Figure 4. Lanxess Profit and Loss A/c (€ Mn)

Year End December	2009	2010	2011	2012	2013E	2014E	2015E
Sales							
Performance Polymers	2,388	3,782	5,059	5,176	4,350	4,708	5,142
Advanced Intermediates	1,104	1,321	1,545	1,674	1,707	1,776	1,847
Performance Chemicals	1,530	1,978	2,130	2,203	2,137	2,244	2,334
Reconciliation	35	39	41	41	41	42	42
Sales Total	5,057	7,120	8,775	9,094	8,236	8,770	9,364
<i>Growth</i>	-23%	41%	23%	4%	-9%	6%	7%
Adjusted EBITDA							
Performance Polymers	250	585	768	817	390	541	643
Advanced Intermediates	154	222	264	305	301	302	305
Performance Chemicals	182	281	289	281	246	280	303
Reconciliation	(121)	(170)	(175)	(178)	(190)	(192)	(196)
Adjusted EBITDA Total	465	918	1,146	1,225	746	932	1,055
<i>Growth</i>	-36%	97%	25%	7%	-39%	25%	13%
<i>Margin</i>	9.2%	12.9%	13.1%	13.5%	9.1%	10.6%	11.3%
Adjusted EBIT Total	204	635	826	849	322	492	583
<i>Growth</i>	-56%	211%	30%	3%	-62%	53%	18%
<i>Margin</i>	4.0%	8.9%	9.4%	9.3%	3.9%	5.6%	6.2%
Net financial charges	(125)	(130)	(128)	(142)	(138)	(130)	(121)
Adjusted PBT	87	521	705	708	184	363	462
Tax	7	(112)	(148)	(154)	(32)	(83)	(106)
Reported Net Income	40	379	506	514	107	278	355
Reported EPS	0.48	4.56	6.09	6.18	1.29	3.34	4.26
Adjusted Net Income	81	401	545	544	141	278	355
Adjusted EPS	0.98	4.82	6.55	6.54	1.69	3.34	4.26

Source: Citi Research, company reports

Figure 5. Lanxess Cash Flow Statement (€ Mn)

Cash flow	2009	2010	2011	2012	2013e	2014e	2015e
Reported net income	40	379	506	514	107	278	355
Minority interest	-1	2	1	1	1	1	1
Depreciation and amortization	261	283	320	378	424	440	472
Cash tax adjustment	-66	-4	10	-78	-80	-83	-85
Other operating cash flow	80	39	91	141	138	130	121
Total other operating cash flow	80	40	93	141	138	130	121
Net change in working capital	239	-220	-256	-118	-52	-101	-113
Cash from operations	553	480	674	838	538	665	751
Capital expenditure	-316	-501	-679	-696	-600	-600	-550
Net acquisitions/disposals	-466	126	-244	22	0	0	0
Cash from investing activities	-782	-375	-923	-674	-600	-600	-550
Change in borrowings	402	-78	620	236	265	128	-13
Dividends paid	-42	-42	-58	-72	-83	-83	-87
Cash from financing activities	360	-120	562	405	181	45	-101
Change in cash	131	-15	313	569	119	110	100
Opening net debt	905	841	954	1,570	1,537	1,802	1,930
Closing net debt	841	954	1,570	1,537	71,802	1,930	1,917
Change in net debt	-64	113	616	-33	265	128	-13

Source: Citi Research, company reports

Figure 6. Lanxess Balance Sheet (€ Mn)

Balance Sheet	2009	2010	2011	2012	2013e	2014e	2015e
Cash and marketable securities	715	524	528	797	797	797	797
Accounts receivable	733	942	1,146	1,527	1,314	1,371	1,435
Inventory	849	1,094	1,386	1,117	1,315	1,400	1,495
Total other current assets	389	368	329	331	305	325	347
Current assets	2,686	2,928	3,389	3,772	3,731	3,894	4,074
Net tangible fixed assets	1,809	2,131	2,679	2,994	3,170	3,330	3,408
Investments	27	21	31	26	27	28	28
Other financial assets	242	244	278	219	230	241	254
Total financial assets	269	265	309	245	257	269	282
Total assets	5,068	5,666	6,878	7,519	7,672	8,013	8,291
Current liabilities	1,119	1,451	2,089	1,630	1,757	1,971	2,053
Long-term debt	1,462	1,302	1,465	2,167	2,167	2,167	2,167
Deferred tax liability	38	40	75	82	74	79	84
Other non-current liabilities	128	156	165	113	114	115	115
Total provisions	876	956	1,010	1,196	1,199	1,202	1,205
Total liabilities	3,623	3,905	4,804	5,188	5,312	5,534	5,625
Shareholders' funds	1,445	1,761	2,074	2,331	2,361	2,479	2,666
Liabilities and shareholders' funds	5,068	5,666	6,878	7,519	7,672	8,013	8,291
Net tangible fixed assets	1,809	2,131	2,679	2,994	3,170	3,330	3,408
Total other non current assets	304	342	501	508	514	520	527
Net working capital	946	1,129	1,405	1,512	1,608	1,685	1,771
Capital employed	3,059	3,602	4,585	5,014	5,292	5,536	5,706
ROCE (post tax)	8.1%	13.6%	13.9%	13.0%	4.7%	6.9%	10.2%

Source: Citi Research, company reports

Lanxess

Company description

Lanxess generates about €9bn of sales. The company's rubber activities generate half of the sales with the other half coming from specialty chemicals (leather treatment, rubber additives, ion exchange) and basic and fine chemicals. The company has undergone a significant restructuring process divesting about €1.5bn of business (by sales) since its formation, including highly cyclical businesses such as styrenics. With the majority of divestments completed, the focus is now on growth by continuing to extract better performance from existing businesses and expanding capacity in Performance Polymers

Investment strategy

We have a Sell (3) rating. Lanxess has so far delivered on cash generation, EPS performance and restructuring gains. In 2010 and 2011 the company benefitted from tight butadiene markets and strong synthetic rubber demand. Pricing has been key to the success story. In 2013, however, we think earnings momentum could stall. More butadiene and synthetic rubber supply and sluggish demand from the tyre industry should lead to a more competitive environment. Higher D&A and pension charges and plant start-up costs should put additional pressure on EPS. Consensus seems to currently underestimate these challenges and we think downgrades are likely.

Valuation

Our target price of €37 is driven mainly by our view of the cash flow potential of the group. Our DCF analysis uses a WACC of 8.8%, beta of 1.5 and long-term growth rate of 2%. We set our target price in line with our DCF-derived fair value of €37.

Risks

We would highlight the following key risks to our valuation and investment thesis.

If some of the announced butadiene capacity expansion projects are not realised, butadiene markets look more balanced. This would provide upside risk for prices and result in a better earnings outlook for the company than currently anticipated by us.

In addition, a stronger-than-expected improvement in the macro-environment would provide upside to our current estimates. We expect tyre markets to remain challenging in 1H13. However, should sentiment improve earlier than expected, we expect LXS customers to come back to the market, which could result in a stronger-than-expected volume development

Appendix A-1

Analyst Certification

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IMPORTANT DISCLOSURES

Lanxess (LXSG.DE)

Ratings and Target Price History Fundamental Research

Analyst: Dominik Frauendienst
Covered since October 8 2010



Date	Rating	Target Price	Closing Price
1 6-Aug-10	2H	*39.00	40.14
2 7-Oct-10	*1H	*55.00	44.19
3 10-Nov-10	1H	*60.00	51.15
4 15-Apr-11	1H	*70.00	55.29
5 11-Aug-11	1H	*66.00	43.96
6 7-Oct-11	Stock rating system changed		

* Indicates change

Date	Rating	Target Price	Closing Price
7 8-Oct-11	*1	66.00	37.67
8 11-Nov-11	1	*63.00	40.87
9 23-Mar-12	1	*73.00	62.67
10 10-May-12	1	*80.00	62.05
11 21-Jun-12	1	*72.00	51.61
12 27-Jun-12	*2	*50.00	47.63

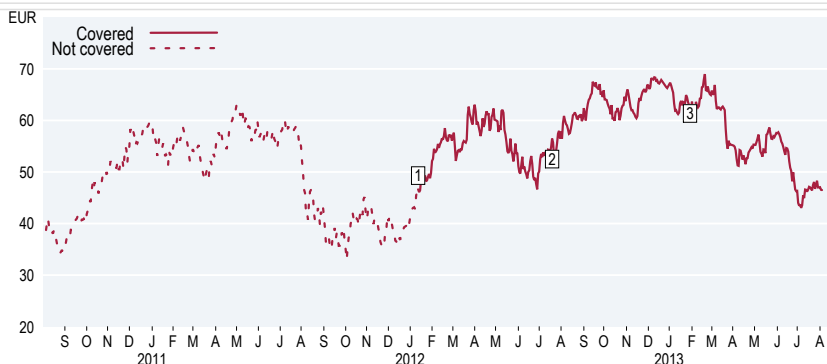
Date	Rating	Target Price	Closing Price
13 7-Aug-12	2	*58.00	60.01
14 8-Jan-13	*3	*56.00	63.27
15 8-Mar-13	3	*52.00	62.21
16 22-Mar-13	3	*49.00	55.66
17 9-May-13	3	*46.00	53.92
18 1-Jul-13	3	*40.00	46.33

Rating/target price changes above reflect Eastern Standard Time

Lanxess (LXSG.DE)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Dominik Frauendienst
Covered since October 8 2010



Date	Rating	Target Price	Closing Price
1 12-Jan-12	*ADD MP	-	46.62

* Indicates change

Date	Rating	Target Price	Closing Price
2 19-Jul-12	*REM MP	-	56.48

Date	Rating	Target Price	Closing Price
3 30-Jan-13	*ADD LP	-	62.41

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Jun 2013

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% of companies in each rating category that are investment banking clients

12 Month Rating			Relative Rating		
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48%	40%	12%	6%	88%	6%
53%	50%	45%	58%	51%	49%

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