Solvay Q1 2023 results

Analysts call transcript

4 May 2023

Jodi Allen - Solvay, Head of Investor Relations

Hello everyone and welcome to Solvay’s first quarter 2023 earnings call. I am Jodi Allen, Head of Investor Relations, and I am joined by our CEO, Ilham Kadri, and our CFO, Karim Hajjar. Today’s call is being recorded and will be accessible for replay on the investor relations section of our website later today. I would like to remind you all that the presentation includes forward-looking statements that are subject to risks and uncertainties. You may refer to the slides related to today's broadcast, which are available on our website.

And with that, I’ll turn the call over to Ilham.

Ilham Kadri - CEO

Thank you Jodi, and good afternoon everyone. I’ll begin with an overview of our first quarter 2023 results on slide 3.

When we spoke to you in February, we shared some insights on our early view of the first quarter, including our expectation that volumes would decline in a weak macro demand environment as destocking effects from Q4 would linger into the first half of the year.

We also said that pricing would offset the volume decline and we were confident in our team’s ability to sustain profitability and margins. And this is exactly what happened. I’m pleased to report that our businesses again did a great job in a challenging inflationary environment, delivering 421 million euros of price, more than offsetting 127 million euros of variable costs. The sustained pricing power was Group-wide, meaning all three business segments delivered pricing that compensated for both variable and fixed cost inflation.

Now let me give you some color on the volumes, which declined -12%. The weak demand was evident across a number of our end markets – as expected, including inEV batteries, where customers continued destocking - this impacted specialty polymers, The agro market was another area where customer destocking occurred, impacting Novecare In construction - we saw reduced demand across several businesses serving this market, including soda ash and also in coatings and in consumer related industries - which impacted Novecare’s home & personal care market and aroma’s food and fragrances markets and we had already planned for the expected normalization of the Coatis business, which significantly impacted volumes.
On a regional level, sales growth in Europe was offset by declines in the US and in Asia; China sales were impacted by the destocking of battery customers, while our consumer-facing markets were impacted by soft demand from China.

The 14% selling price increase enabled us to fully overcome the volume decline and deliver 2% organic sales growth. The strong pricing momentum and our continued focus on cost discipline drove organic EBITDA growth of +22% in Q1, higher than our initial expectations. This translated into EBITDA margin expansion of +320 basis points, reaching a new record of 26.5%. Keep in mind this is in comparison to Q1 last year where our pricing initiatives were only beginning to take traction.

Looking back over the last 12 months, our EBITDA margin averaged 24.8%. Moving to CASH, I’m pleased with our continued track record of positive free cash flow generation for the 16th consecutive quarter. This has been one of my key priorities and areas of focus since taking the helm at Solvay over four years ago.

You may recall that we committed to delivering Free Cash Flow conversion above 30%, and we have consistently delivered on that metric. And we expect to maintain that discipline, even in a higher investment cycle. I am pleased to report that our Free Cash Flow amounted to 125 million euros this quarter, and you’ll notice that this is despite the significant increase in working capital. That increase reflects the choices we made to invest in inventories to better serve our customers. Karim will give you more details on that later.

Earlier this year, we shared our plans to invest in our future growth, and indicated a higher capital spend this year. In the first quarter, our Capex reached 212 million euros, 40% higher than in Q1 last year. The growth projects this year include Specialty Polymers investments to address the future needs in a variety of markets; this includes the expansion of our sulfone technologies in the U.S. to support our healthcare customers' growth. It also includes our investments in PVDF in France to support future growth in EV batteries. We are investing in a new generation of green solvents in our Melle, France site which aligns with our ambition to bring more sustainable solutions to the agriculture market. We also announced a new bio-circular highly dispersible silica process at our Livorno Italy site, utilizing bio-based sodium silicate derived from rice-husk ash. Finally, as you know, we are investing in our natural Soda Ash expansion in Green River, Wyoming.

Aside from our investments in capacity, we also continue to bring new innovations to the market. The Novecare team launched a new naturally derived, guar-based solution called Polycare for the beauty care industry. And Specialty Polymers introduced a new high performance polymer to address the high-heat and electrical insulation requirements in EV batteries.

I'd also like to highlight some other recent announcements. In March, our 2030 Climate targets were approved by SbTi. This validation reaffirms Solvay's target to reduce Scope 1, 2 and 3 emissions, as set out in our Solvay One Planet sustainability roadmap and reflects our ongoing commitment to raise the bar in tackling climate change. We also streamlined our portfolio with the sale of our 50% stake in RusVinyl and received €432 million in cash proceeds at the end of March.

And I'm always pleased to share our latest customer highlights and new partnerships. Our Aero team was recently recognized by Northrup Grumman and won a prestigious quality excellence award in March. We have been partners for over 40 years and this demonstrates the team's ongoing commitment to quality and service excellence. Just last week we signed a license agreement with GHCAC in China which will enable them to build and safely operate a hydrogen peroxide unit [in Qinzhou] designed to support another propylene oxide (PO) production facility.

Finally, I'm really excited about our new strategic collaboration with Ginkgo Bioworks that we announced in April. They are a recognized leader in synthetic biology. Through this partnership we acquired a lab in Cambridge, Massachusetts which will establish a growth base in one the most important biotech hubs in the world. The alliance will focus on new sustainable biopolymers and specialties which could address a breadth of markets, from home and personal care to agriculture and food.

It's only the start of the year and we have many achievements to be proud of! And now I'll give the floor to Karim who will review the segment results and financial highlights. Karim?

Karim Hajjar – CFO

Thank you Ilham. Good morning and good afternoon everyone. Today, as usual, I will present figures on an organic basis, which means at constant scope and currency unless otherwise stated.

Starting with the Materials segment, sales increased +16% to €1 billion. The driving force behind this growth was the increase in prices of +17% and this more than offset a modest reduction in volumes for the segment of -2%.

Sales in Specialty Polymers improved by +15%, driven by higher prices as customers continue to value our lightweighting solutions that provide mission critical performance while reducing CO2 emissions. Volumes were slightly down due mainly to reduced demand in EV batteries as customers continue to reduce their high inventories. This impacted the demand for our PVDF, though its important to note that our PVDF suspension technology offers a differentiated value proposition specifically for the high end battery applications (NMC) which supports margins in the current deflationary environment. Sales grew most notably in the Electronics market where our polymers are used in semiconductors, as well growth in our Life Solutions sector, where polymers are used in pharmaceutical packaging & hemodialysis.

In Composite Materials, sales increased +17%, due to both higher volumes and prices. We witnessed a continued demand recovery in civil aerospace driven by build-rate increases in single-aisle aircrafts, as well as growth in space & defense programs though volumes for high-performance automotive were down slightly. Although inefficiencies plaguing the aerospace supply-chain persist and continue to put limitations on production and orders, overall the aero market recovery is clearly underway.

Thanks to the volume and pricing gains in the segment, Materials EBITDA increased by +35% with an EBITDA margin of 35.4%, marking a +600 basis point improvement versus Q1 2022.

Turning to the Chemicals segment on slide 7, segment sales for the quarter increased +2%, reaching €1.1 billion. This is due to our well-placed pricing measures delivering +17%, more than compensating for reduced demand which impacted segment volumes by -15%.

In Soda Ash & Derivatives, sales growth of +19% was driven mainly by higher prices. Demand remained strong for soda ash used in container glass, photovoltaics, and in lithium processing, as well as for Bicar used in pharma. This partially offset modest temporary demand weakness in the construction and detergent sectors and the fact that we continue to prioritize pricing over volumes in select cases of new business opportunities, particularly in the seaborne market. Such performance further demonstrates the resilience that we've seen over the past years as highlighted during our webinar on February 27th.

Peroxides sales were down -6% in the quarter due to lower volumes which offset pricing gains compared to Q1 2022. In particular, demand for HPPO used in auto and building & construction industries softened, whereas demand for peroxides used in food and disinfection industries remained stable.

In Silica, sales increased +6% in the quarter driven by pricing actions that were able to more than compensate for softer demand in the tire market. The fact that we work hard on developing innovative sustainable solutions that our key customers appreciate adds to the resilience of our business. We were really pleased to see that one of our key customers, Bridgestone, launched in January its "Turzana 6 tire" delivering best-in-class safety and fuel efficiency performance – and we are proud of the fact Solvay's silica is a part of this exciting new product launch.

Sales in Coatis were down -29% versus the strong comparable of Q1 2022. You may recall that this business delivered strong performance in exceptionally supportive market conditions over the past 2 years and we fully expected this to normalize as low priced exports from competitors in China and India impact market prices.

Wrapping up Chemicals, segment EBITDA rose +19% versus the previous-year quarter, driven by sustained pricing in our Soda Ash & Derivatives and Silica businesses, supporting an EBITDA margin of 27%, an improvement of 3.4 percentage points when we take into account the divestment of Rusvinyl.

Turning now to the Solutions segment, first quarter net sales in the segment were down -9% reflecting a -16% reduction in volumes which was partially offset by higher pricing of +8%.

Starting with Novecare, sales decreased -14% versus Q1 last year due to continued softness in consumer market demand, a dynamic which we started to see in Q4. Sales to the Coatings market were impacted by low building activity. The home & personal care market was also impacted by continued weak consumer trends, particularly in China. In Agro, weak demand was driven by higher inventories in the value chain and delays in the planting season in certain regions. In general, pricing was positive in the quarter, reflecting a continued improvement in mix and decisions to prioritise profitability based on maintaining a pricing-over-volume strategy.

Special Chem sales increased +4% mainly reflecting higher prices. Volumes in automotive and industrial applications were stable, while demand for electronic chemicals was softer than Q1 2022.

Sales in Technology Solutions in the first quarter increased +15% due to higher prices and higher volumes driven by strong demand in copper mining and phosphorus derivatives. Demand for copper is expected to remain strong, helped by a recovery of Chinese economic growth.

Aroma Performance sales decreased -31% in Q1 driven by lower demand in vanillin used in flavors & fragrances markets and inhibitors used in monomers. While the food & beverage market is expected to remain resilient, the fragrance market faced strong price-led pressure from Chinese competitors. This is another example where the business has chosen to preserve pricing over volumes, whilst initiating further actions both to reinforce the competitiveness of our business and to invest in the industrial scale-up of natural vanillin.

Oil & Gas Solutions sales fell -18% compared to the same quarter of the previous year, mainly due to a sharp decline in natural gas prices that resulted in decreased drilling activity.

First quarter EBITDA of the Solutions segment declined -9% year-over-year due to lower volumes across the segment while the EBITDA margin remained flat at 21.1%. This is noteworthy when we compare the 21% margin to the 17% and 18% of a few years ago.

The EBITDA contribution from Corporate and Business Services activities in Q1 improved by +€25 million versus Q1 2022 as we report the benefits of the stabilization of our energy activity including a net favorable impact of approximately €11 million.

On slide 9 you'll see that EBITDA increased +22% to €839 million euros, mainly due to sustained strong pricing. You will also notice that the fixed costs increase of €24 million was below the levels of prior quarters, resulting from both continued structural cost reductions and lower spend on group-wide investments such as digitalization and cyber security. As a result, EBITDA margin improved by 430 basis points to a record 26.5%.

Moving on to slide 10, we continue to make progress toward our strategic goal of €500 million in total savings, delivering €17 million in Q1. Cumulatively, structural cost savings now amount to €484 million since 2020, or 97% of our 2024 target. We also took an €80m restructuring cost provision as we take actions to cut costs further. We're not going to stop looking for more opportunities, as we seek to anticipate and contain future dissynergies associated with our Power of 2 project, though we'll give you more details on these later in the year.

Our free cash flow in the quarter was €125 million. As Ilham mentioned, this reflects our strong profits, our growth investments in capex and in working capital and a benefit related to the successful resolution of a litigation.
In so far as working capital is concerned, our receivables remained very tight with average DSO of 43 days and overdues at a record of 1.5%. You will remember that we ended 2022 with a low inventory balance and so we invested in building inventories this quarter because we remain focused on being well-placed to supply our customers throughout the year. Payables are lower mainly due to lower energy and raw materials prices. We are adapting to the demand environment and we expect working capital intensity to reduce over the next quarters as we remain resolute in driving cash generation.

And now, a few words on our net debt. The underlying net financial debt was further reduced in Q1 by €339 million to €3.25 billion, reflecting positive free cash flow and €432 million in proceeds from the Rusvinyl disposal.
All in all, our balance sheet is stronger than it has been for a decade and these improvements have enabled us to achieve an historic level of Return on Capital Employed of 16.7% – more than double the 8.1% reported at the end of 2019. This reinforces our ability to create two champions by the end of the year.

With that, I'll hand you back to Ilham to discuss the outlook and make closing remarks.

Ilham Kadri - Solvay - CEO

Thank you, Karim.

Let me provide some insights into our upgraded full-year guidance. We have again demonstrated this quarter our ability to maintain our hard-won pricing gains, more than overcoming inflationary pressures. Looking into Q2, our April order books indicate continued weak demand. At this time we have limited visibility into May and June and we therefore do not bank on any recovery in volumes in the second quarter. It is also important to note that we have a tougher comparable quarter as our pricing actions began to take effect in Q2 last year on top of solid volume growth.

We therefore expect Q2 EBITDA to be sequentially lower than Q1. We remain confident in our ability to maintain strong margins, and we have upgraded our full year guidance range to reflect our current forecast. We are raising full year 2023 EBITDA guidance, on an organic basis, to a range of +2% growth to a decline of -5% – a significant improvement from our previous guidance of a decline of -3% to -9%.

As you can expect, this assumes that there will not be a significant change in the prevailing macro environment, and indeed this range reflects different trajectories between now and the end of the year. At the lower end, we foresee a scenario of volumes stable at current levels and some modest gross margin erosion in select product lines. At the higher end, we anticipate profit growth based on modest volume recovery in the second half of the year, and an expectation that we will sustain leading margins across much of the portfolio.

On Cash, as a result of our upgraded profit expectations and improved performance, we are raising our full-year free cash flow guidance from €750 million to around €900 million. We still intend to increase our capital investments relative to last year as we remain resolute in our determination to ensure that we sow the seeds for future growth.

To conclude, I remain confident in the capabilities of our people – they continue to demonstrate an ability to deliver and overcome significant challenges. We are a stronger company today, and our balance sheet keeps us well-positioned to progress on our separation journey which will unlock value for our customers, shareholders, and our employees.

And with that, Karim and I are happy to take your questions.

QUESTION AND ANSWERS

Jodi Allen - Solvay - Head of IR

Thank you, Ilham. We will now move to the Q&A session. And I ask that you kindly limit yourself to one question per person so that everyone has an opportunity to participate. We will be managing the queue directly today. So if you wish to ask a question, please dial star one-one on your telephone keypad and you will enter the queue. Once again, dial star one-one to ask a question. Our first question today comes from Wim Hoste from KBC. Wim, please go ahead.

Wim Hoste - KBC Securities

I wanted to dive a little bit deeper into the PVDF market dynamics. Can you maybe indicate how far the destocking has gone at the customer level? And also what has the destocking trend caused to pricing dynamics in the market? I know you have different technology in the mainstream and you're in the higher ends, but can you maybe also elaborate on the pricing dynamics for your products and the market overall in PVDF?

Ilham Kadri - Solvay - CEO

Yes. Thank you, Wim. Indeed, as Karim and I have told you that there has been a destocking which will continue probably to quarter 2 as well in general, in batteries in automotive. But as you've seen, frankly, and I will come back to batteries, our business is not only PVDF batteries. You've seeing Specialty Polymer really doing well, including in other applications in auto under-the-hood. We're in the business of light-weighting, electrification, but please do not forget light-weighting.

On PVDF, Wim, yes, there has been a destocking on EV batteries and you've seen it in many other publications. We expect it to continue over quarter 2 this year. On the differences, and I think we've tried to do some education on emulsion versus suspension PVDF, Karim alluded to that again. There are 2 types of PVDF technologies for EV batteries– suspension and emulsion. No one material is inherently better or worse than the other, and we produce both.

But the reality is that suspension-grade PVDF in which Solvay is the world leader, has a set of properties that makes it better suited for nickel-rich, high-energy density cathodes like in lithium-ion batteries and specifically with NMC, which is the high-end battery type in the market.

The suspension is the reference binder material in the production of those NMC materials. There is basically no emulsion PVDF used in NMC today. I know people are still trying to get there, but this is mainly suspension. And emulsion PVDF, its commercial products available worldwide with Chinese competition. We expect that to be more commoditized in the midterm and with very little to no significant penetration in the high end in NMC.

What has happened, for us, obviously, there is a raw material cost decrease. For us, we just kept our margin constant and even as compared to the end of last year. Without giving you that much numbers and sensitive competitive information, our Q1 PVDF battery margins have been stable compared to the end of last year. That's the message, that's how we ask our team to fight for value pricing on PVDF.

We are more resilient than other technologies. We like our investments that we are doing in Europe and in the U.S. in suspension PVDF because the barrier to entry for imports, for example, from China, like in the United States of America are pretty high. The tariffs are high, more than 30%. All of this makes our strategy very sound for future growth CapEx. Back to you.

Operator

We now have a question from Martin Roediger from Kepler Cheuvreux.

Martin Roediger - Kepler Cheuvreux

The question is about Chart #9, where you show that the Scope effect was plus €7 million on sales but minus €36 million for earnings for EBITDA. Can you explain that gap?

Karim Hajjar - Solvay - CFO

Sure. That's mainly RusVinyl, which you recall was equity accounted. Hope that helps. It's the simplest answer that I can give you. Thanks Martin.

Operator

The next question comes from Andreas Heine from Stifel.

Andreas Heine - Stifel Europe

Okay. On the sequential earnings trend, you said that earnings in the second quarter are probably lower than Q1. Looking at the explanation for that, it is probably not volume. Volume is not getting better from Q1 to Q2, as you said, but Q1 was already pretty low, and probably Q2 is not worse in volume. So it probably has to do with margins then, and if that is not across your portfolios, maybe one or the other thing might be weaker than the general trends. Could you outline where you think that the Q-on-Q earnings decline might come from?

Ilham Kadri - Solvay - CEO

Yes. Thank you, Martin. I think our quarter 2 -- and we have April in bed internally, but a month is not a quarter. But definitely – and you could see it across all other peers and our customers who have published. Our quarter 2 order book volumes remain low. Therefore, we expect demand to remain soft. And we do not see yet any improvement in consumer, construction or batteries, by the way, I just mentioned that there will be still some destocking.

Some markets could soften further like semiconductors. Therefore, we see quarter 2 sequentially lower than quarter 1 and that's what we see today. We gave you the low and the high range of the guidance betting on H2, either there is some recovery of the volumes or not. Knowing that there is a seasonality between H1 and H2 in general. Our quarter 2, to give you some ideas, can be anywhere between 5% to 10% below quarter 1, to give you some precision.

Operator

Next question will come from Alex Stewart from Barclays.

Alex Stewart - Barclays

Well done on the results. You raised guidance 3 times last year, and you've raised guidance once already this year. The price increases that you've been doing, if they were indeed part of your overall strategy, then why have you had to raise guidance so many times because to my untrained eye, that would suggest the results were coming in better than you'd expected rather than as you'd expected. So I'm really interested to hear your view on that if possible.

Ilham Kadri - Solvay - CEO

Alex, it's a good question, by the way, remember, Alex, back in the fall of 2021, we told you that we are going to start working on our value pricing. Quarter 4 2021, so the fall 2021, we started not knowing what 2022 will look like, and we have trained more than 1,000 of our sales people on value pricing.

We renegotiated and we opened thousands of contracts to look at our formula pricing. That's why last year, when inflation picked up as a consequence, specifically in Europe, with the crisis in Ukraine, we were ready to do a good job. Frankly, nobody has a crystal ball, [but some forecasts] are probably sharper than others in usual times.

But when visibility is reduced and sensitivity is higher, what I do normally– my wisdom is not to waste a good crisis. We are training the muscle called "pricing" Part of our portfolio and this is probably 50/50 – one part is linked to supply/demand, when supply is tight and you know what it takes and when inflation is there– we are baking in formula pricing linked to raw materials and energy. Soda Ash is one of the good examples where we told you we are doing just that, Silica is another one.

The other part is value pricing– in value pricing, we have been testing our portfolio where pricing is going to be sticky and frankly, we are learning. Over the last year, I've been learning a lot personally on the portfolio and its stickiness and where we have a differentiated value at the product level. We've been pruning the portfolio. You've seen it in Solutions, for example, where we have been making calls on pricing versus volume, and we let go of some of the low-quality products we just didn't take, also in the Seaborne market in Soda Ash, for example.

So I think that by testing the market, we better understand our competitive edge. In quarter 4, we told you that we are going to continue defending our value pricing– our margins. Now as you've seen, the EBITDA margin over the last 12 months has been at 24.8%. And without RusVinyl, the IR desk can give you those data, we did it actually. We removed RusVinyl since I joined the company, we have been gaining 1 percentage point every year in margin, those are leading specialty margins. That's what we've been doing. If we can get the same level of record margin as last year, this year, I will be more than happy, while we will go and outperform the market in terms of volume. So that's, I think, what's the gain this year while continuously testing our value pricing and some of it should be sticky and will stay with our portfolio.

Alex Stewart - Barclays

Perhaps if I ask that in another way. When you and Karim were chatting at the beginning of last year, were you expecting Solvay to deliver €3.2 billion, €3.3 billion of EBITDA or was that above your expectations, this time a year ago?

Ilham Kadri - Solvay - CEO

Our teams surprised us, Alex. You remember the €3 billion was even a big event in this company because since 10 years, we were looking at that. Now, obviously, we didn't have a crystal ball earlier this year. The pricing was new in this company, in quarter 4, we trained the muscle. I remind you when we started in March, and we started our real campaign in pricing, we had a few contracts negotiated, but the team really outperformed and surprised us. Now I think what is important, the end of last year, we started really going forward with value pricing against supply/demand and formula pricing. Makes sense, Alex?

Karim Hajjar - Solvay - CFO

Just to remind you, we had a war that had started, we had inflation that had never been foreseen. So all of that added a greater degree of uncertainty, so we're really pleased with what the team has delivered in that context now.

Operator

Our next question comes from Geoff Haire from UBS. Geoff?

Geoff Haire - UBS I just wanted to come back to the guidance and the comments you made about margin erosion in certain product areas. If you look at the low end and high end of the guidance, are the areas that you expect to see margin erosion the same as those that you'd expect to see margin recovery and at the high end. And could you give us some examples of where that margin erosion or recovery might come and which businesses?

Ilham Kadri - Solvay - CEO

The demand dynamics are still uncertain, in this world, and that will continue. Now as we told you, the pricing comp will obviously be more challenging as quarter 2 last year was particularly strong in this respect. Now in our guidance, we don't expect much of the improvement in the macro environment. Volumes are still under pressure due to the soft demand across many markets, as we mentioned. That's specifically quarter 2.

Net pricing remains positive, but again, against a very strong comparable quarter versus last year. So that's why I even gave you some color on quarter 2 EBITDA sequentially lower than quarter 1. H2 levels will depend on the level of volume recovery, as we told you. So we have very little visibility now. Finally, do not forget our usual seasonality, H2 is usually lower than H1 with quarter 4 being the lowest quarter of the year. So that's the main thing you need to keep in mind. Frankly, we'll see how quarter 2 will develop. Obviously, we will come back to you.

On the business unit level or business level, we expect Materials and Chemicals to continue to do better in this environment. Although in some areas, like batteries, the destocking will continue. Solutions will recover more gradually. But again, we are taking our destiny in our hands, and we are really choosing to let go of some volumes if they have low profitability.

I remind you that this company had a problem with the return on capital employed in 2019. Just 4 years ago, it was 8%, and we had an issue of profitability of our assets. We don't want to go back to fill the pot, to grow with profitable products, we will keep that in mind, and that's how we are looking at the portfolio. Make sense?

Operator

Our next question comes from Chetan Udeshi from JPMorgan.

Chetan Udeshi - JPMorgan

My first question– I was a bit curious: why did you feel the need to invest in inventory in this sort of environment, where maybe like you said, volume visibility is quite low. So like what drove that inventory increase in Q1, like did the demand end up worse than what you guys were expecting through Q1, I was just surprised.

And second question was, if I look at the guidance raise on EBITDA, it's roughly, I think, €100 million to €140 million EBITDA guidance, increase -- but the free cash flow is going from €750 million to €900 million, €150 million delta out of which €90 million is from the payment from the previous owner of one of your assets. So where is the remaining EBITDA increase going in terms of free cash flow contribution? Why are we not seeing a bigger increase?

Ilham Kadri - Solvay - CEO

Great question. I'll take the working capital, Karim, maybe the free cash flow later. Frankly, the working capital was the million-dollar question when we started the year. I'll remind you, Chetan, that at the beginning of the year, we started with a very low working capital percentage of sales in quarter 4, that's #1. Nobody knew, and I remember even with you guys and others, some peers stated Q1 is going to be a disaster and others, "we don't know." We had our own guess, but frankly, we don't have a crystal ball.

The answer to your question is simple, it's customers, customers, customers. Our customers, and we have now since 2020, by the way, this is one of the positive things of COVID, we have a central order book where we go back bottom-up from customers, understand their needs– because at the end of the day, I want to be ready, whatever happens– to supply customers' needs.

The working capital, indeed, in quarter 1, is higher. It's approximately €300 million to €350 million above historical level, an increase of about 10% of net working capital, Chetan. When you take into account the effect of price and cost inflation, frankly, such an increase could have been expected or is expected. We've done it by choice because we entered the year again with low inventory and we didn't know how the market would evolve. We had several contradictory opinions on the development.

So you need also to look at inventories and payables, in inventories from a low level. We decided to invest to meet customer demand and markets like Aero to address the ongoing recovery. We have some markets in mining where our technologies are needed, to support the copper extraction, the agro season, and we expect this to be temporary, and we will go back to normal levels later in the year.

The second is the payables and they are lower than usual, primarily because of further sequential reduction of variable cost, energy and raw materials, you will see the impact in the coming quarters. And also because we buy less raw material as we intend to decrease our inventories. Despite the increase, we are doing much better than many of our peers, the ones who have published at least. We're approximately 17%. I asked the team actually to give me some median of the peers and they are at 30% plus.

I don't regret that decision or that call by the Business Presidents, because of some of our material performance, some markets, the volume increase, and we were at the rendezvous. I think those are business calls, and I don't frankly regret it. I think it was the right thing to do, and we still have 3 quarters to fix the working capital as a percentage of sales.

Karim Hajjar - Solvay - CFO

And your question, Chetan, on why is the free cash upgrade relatively modest in the context of I think you said €150 million profit guidance improvement.

So I think there are 3 components. One, you rightly pointed out, we have a €92 million, let's say, unplanned in our initial guidance of the year, litigation settlement. That leaves you with a €60 million improvement because we said around €750 million to €900 million. So 2 other factors are: one, the effect of the higher guidance and profits, less working capital, less tax effects. Now, I'll come back to that. For the avoidance of doubt, we are, at this stage, not planning to change our CapEx investments compared to what we said earlier in the year.

So why does €150 million-ish of higher profit increase, increase the cash by €60 million, it's really to do with working capital and taxes. We're looking here at a cash conversion on the incremental profit around 40%, which is stronger than on average, as you note, but also it's important to note the phasing of that increase. If it's very back ended, let's say, towards Q4, much more challenging to crystallize into cash before the end of the year, that's part of the judgment we apply as well in looking at it. But any extra profits we generate will be crystallized into cash, and we'll do what we can to make sure it happens this year.

Operator

The next question comes from Jaideep Pandya from On Field Investment.

Jaideep Pandya - On Field Investment Research

Could you give us some color on the debt structure for the 2 companies when they are going to come into the separation? And also just an update on the time line considering a lot of volatility in interest rate markets these days, how confident are you that there is no risk of a significant increase in interest burden for both the entities? And the second question, sorry to ask this, but to Ilham, I mean, you've done a phenomenal job in price versus raw materials, really almost €1.3 billion now if I look back to early 2022 through Q1 this year. In your experience in the industry, have you ever seen something like this, because it is fascinating for us from the outside in for Solvay to report these kinds of results. And we're obviously all scratching our heads in terms of sustainability of this. So just some color, some confidence as to if you can retain most of this €1.2 billion to €1.3 billion, that would really help us understand the new Solvay better. Well done again on the results.

Karim Hajjar - Solvay - CFO
Jaideep, let me just, first of all, start to address your questions, but I won't be able to answer everything at this point in time. And I'll start by reminding you that we said a few weeks ago that we'll be giving insights on the capital structures in the June- July time frame. So I'm going to ask you to please be a little patient. We want to finish our work, we're going to do really well. So what should the capital structures be, and I'm going to come back a bit about that in a moment. But the good news is our leverage is lower than it's been, our cash is really strong. We've said consistently, we're going to create 2 strong companies with strong balance sheets. And I'm going to say we are spoiled for choice, but we have a very, very strong Solvay balance sheet as we head into this.

Now once we finalize our own assessment of the capital structures, we will finalize our plan on the liability management. What we do with the bonds, how we incentivize, motivate, discuss with debt investors to see the strength of the balance sheet of both companies– that's the plan. Now in doing that, you talk about high interest rates, et cetera. Let me just say this. We have more than adequate liquidity reserves. We will completely, you can expect us to adhere to normal market practice in these situations. And honestly, we think that people will see the strength of the balance sheets, and we will see the logic of responding to the opportunity that we put before them. But I'm not going to go into more than that at this stage beyond the fact that we have a lot less debt at the net of €3.25 billion than we've had for years. So for the rest, Jaideep you asked because what we do there will actually directly be linked to what we share with you in June- July on the capital structures of both companies.

Ilham Kadri - Solvay - CEO On the pricing and thanks for the words, phenomenal job actually on more metrics, by the way, than pricing. I mean this company looks very different and smells different than back in 2019. I remind all that we've been through this transformation, financial transformation and non-financial, by the way. I'm so proud of the debt reduction, the one time today, just put us in a very solid position to have choices we didn't have just a few years ago.

The underlying EBITDA margin. I told you without RusVinyl now, which we exited fully, and we are glad about this. We have improved our EBITDA margin, which was already best-in-class specialty margins– 1 percentage point every year. And the free cash flow, and you know it, we were very much a laggard in our peer group, and we promised you 30% at least, to be in that league. We performed and we became a free cash flow machine and delivered on the return on capital employed.

If there is one thing I'm very, very proud of with the employee engagement by the way, which is close to my heart is the ROCE. We were at 8%, that was where we were basing with the cost of capital– and we doubled it. This is not an easy one, by the way, because you need to prune the portfolio, you need to choose your products and you need to choose the customers as well.

So here on pricing, I think we moved from selling products to selling value. That's a big mindset shift in the company. It's not easy in my career, I've seen it in my previous companies, you need training, you need to know how to sell the value. And you need to understand which value you create with your customers and share the value created.

I'll give you an example, when I replace a piece of metal under the hood application in any automotive customer, it's not about the euro per kilo of the polymer I'm giving away, it's not that, it's about the value I create by replacing metal at lower weight, therefore, consuming less fuel, emitting less CO_2 at a lower total cost of ownership.

And now we agree with our customers what's the value created and then we share the value created. So that's it, and I think the net pricing, solid pricing power, whatever, means pricing net of the variable cost and fixed costs. And our salespeople are measured, rewarded, we even have CEO awards in the company by now on those net pricing, which before was even on the volume side. So I think all of this is important.

On the second thing, and I know you all have questions in your heads, and I think time will tell. We have been telling you now for more than 1 quarter, a few quarters – that's the fourth quarter in a row, half of our business, half of our portfolio is supply-demand related, and in a tight supply situation, in a safer area, you can push your prices, et cetera. And you know where we have tight supply. But more importantly is that we reviewed our formula prices. We reviewed the components of energy and raw materials and we put surcharges and you've seen that last year.

And there, if energy or raw materials go up and down, we give back to our customers because we want to protect our margins. And around half of the portfolio is more specialty. And there, we are experimenting, we've been experimenting, now we are reinforcing areas where we sell a strong value proposition based on customized, innovative solutions designed to meet the customers' needs. And I think that's important. And that's new in the company. And obviously, I'm calling on our teams to continue fighting for that. And it's about being offset by the value we create for our customers. But again, not leaving it all on the table, it's about sharing in the value creation.

Operator

At this stage, we will take 2 more questions. Matthew Yates from Bank of America is the first one.

Matthew Yates - Bank of America

Might actually be a follow-up on the last question. But specifically on the Materials division, if I look at your Q1 sales, they were a touch below Q4, yet your EBITDA went up by €60 million sequentially or about 20%. Just why would profitability be so much better Q-on-Q as the top line hasn't really changed. Do I infer from this that you've already started to see a drop in your raw material inputs that haven't been passed through in pricing? Obviously, 35% margins is pretty phenomenal. So is there a risk here and that's embedded in your Q2 guide that there are some products, perhaps with formulation clauses that kick in with a lag or you need to give back some pricing in Q2. So I just really want to understand why Q1 was so good relative to Q4 and the sustainability of that into the coming quarters.

Ilham Kadri - Solvay - CEO

Yes, it's a good question. I think the volumes, and I talked about the destocking on the PVDF side. And we are more resilient than others because, again, our Specialty Polymer portfolio generally is not only automotive, by the way, is only one sector , it is not only batteries. So, I think the diversification which investors do like in Specialty Polymers is really a good thing.

We had many markets within Materials delivering volume growth with only batteries down. So in Specialty Polymers, we have a new fab equipment supported growth for our polymers using electronics. We also delivered volume growth, for example, in health care applications, such as pharma packaging. I remind you, we are in pharma packaging. In hemodialysis we're one of the few leaders in hemodialysis in the world, and thus have been picking up nicely. I like this business since the COVID times.

Something important to note is while polymer demand for EV batteries was low due to destocking, polymers for auto non-batteries grew in the quarter in under-the-hood applications. And of course, composite volume growth, I think we mentioned it in our prepared remarks, is linked to the ongoing recovery in civil aero and we are not back at 2019 levels by the way.

So the pricing level versus last year, the business has demonstrated its ability to maintain higher pricing which was the main driver of the growth. So that's value pricing. I'm not going to repeat my favorite case and story of replacing metal under-the-hood. Customers come to us when they have many needs, like they need chemical resistance, bridging resistance, et cetera. So as many as needed, they come to us. So that makes us very differentiated.

And even, by the way, when you look at our battery products. In the destocking, we kept the margins. The percentage on sales -- the EBITDA margins for those products or gross margins for those products became stable.

So over time, we will continue value pricing our solutions. While in some applications, we will get back pricing when raw materials are favorable. By the way, we did this somewhat in batteries because 142B prices, for example, for those who know the Level 2 or 3 of the formula of batteries and PVDF– we gave away some price, but we protected our margins. We sustained margins when -- even when the batteries volume and destocking is happening.

And longer term, we have specialty margins here, that's what we are talking about. And we will look for more profitable volumes because given light-weighing and electrification, we will continue penetrating with those technologies, like in composite, whatever the market there. So it's value pricing, not value based on cost plus. I think that's what you can expect from us in the specialties and in Specialty Polymers, specifically. Back to you.

Operator

Our last question will be from Sebastian Bray at Berenberg.

Sebastian Bray - Berenberg

It's on the segmental -- subsegmental profit contributors to the Materials segment, and it builds on the questions asked earlier. Between Q4 of 2022 and Q1 of 2023, was there a significant change in the profitability in absolute terms of the Composites business. In other words, what we are seeing in terms of EBITDA improvement is largely due to Specialty Polymers or the mix between the two is more even?

Ilham Kadri - Solvay - CEO

Yes. Thanks for the question. We don't give, obviously, guidance and sensitive information at a granular level between Specialty Polymers and Composites. But as you know, when I joined in 2019, I already told you at that time that I didn't like the Composite Materials margins, and we're going to do a turnaround and really fix the profitability. And that's why -- and 2020 helped us, it was tough. It didn't go without tears and pain because we had to shut down a few assets which had the lowest return on capital employed in Composite Materials, which helped us actually to move products in other places, into other existing manufacturing sites which helped us fill the existing capacities and do a better job there.

So as we recover, as aero is recovering, you will see improved margins here and there, but it's across the board. I think Specialty Polymers again did a great job. I think the value pricing there was one of my dreams at the beginning. I told you it is the crown jewel. I knew that we needed to train. We need to understand better our value pricing. But there is no particular outlier.

I'm very pleased, again, with the whole Materials segment, Specialty Polymer delivering strong results outside that region, even in batteries, they kept their margins, so I cannot ask for more. And this shows the strength of our diversified and unique portfolio of polymers that customers value, and that's the sincere story and we'll continue testing. I think you cannot imagine how much work is going behind the curtain in this company. Each business is actually delayering. We are opening one after the other and understanding where we are differentiated, where we are not, where we are leaving value behind us, where we don't value our products enough. And no one has the strength and the depth of our Specialty Polymer portfolio, I truly believe it. And we're going to continue to defend margin. And through innovation, we'll do even better on value pricing. Back to you.

Jodi Allen - Solvay SA - Head of IR

Well, I think we've reached the end of our call. So I want to thank everyone for your participation today and remind you that the Investor Relations team is available if you have any further questions. Thank you so much, and have a great day.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you all for your participation. You may now disconnect.