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LIN.N - Q1 2020 Linde PLC Earnings Call

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## OVERVIEW:

Co. reported 1Q20 sales of \$6.7b and 1Q20 EPS of \$1.89.



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## CORPORATE PARTICIPANTS

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## PRESENTATION

### Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Q1 2020 Linde Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) I would now like to hand the conference over to your speaker today, Juan Pelaez, Head of Investor Relations. Please go ahead, sir.

### Juan Pelaez - Linde plc - Head of IR

Thank you, Racquel. Good morning, everyone, and thank you for attending our first quarter 2020 earnings call and webcast. I am Juan Pelaez, Head of Investor Relations, and I'm joined this morning by Steve Angel, Chief Executive Officer; and Matt White, Chief Financial Officer. Today's presentation materials are available on our website at [linde.com](http://linde.com) in the Investors section. Please read the forward-looking statement disclosure on Slide 2 of the presentation and note that it applies to all statements made during this teleconference. The reconciliations of the adjusted numbers are in the appendix to this presentation. Steve and Matt will now give an update on Linde's first quarter performance, and we'll then be available to answer questions. Let me turn the call over to Steve.

### Stephen F. Angel - Linde plc - CEO & Director

Thanks, Juan. I am very proud of how our employees all over the world have responded during this crisis. Through our business continuity plans, including our remote operating capability, we have been able to continuously serve our customers while keeping our employees safe. We ramped up supply of vital medical oxygen to help our community hospitals fight this virus. We installed oxygen equipment for emergency and temporary care facilities practically overnight. Our employees performed heroic acts to get critical respiratory equipment like ventilators to people in need.



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We commissioned air separation plants for Samsung in the middle of this crisis in South Korea. And throughout all of this, we maintained best-in-class safety performance.

Our respiratory home care business in the U.S., Lincare, has become an important second line of defense to fight COVID-19, providing ventilators to hospitals, transitioning thousands of patients from hospital to home care and maintaining continuous respiratory care for their base of 1.6 million home care patients. Some of you are aware that Linde has entered the market to provide inhaled nitric oxide therapy to patients in the U.S. Inhaled nitric oxide is most widely known as a treatment for infants in respiratory distress, commonly known as blue baby syndrome. But more recently, nitric oxide has been used as a treatment for COVID-19 by doctors around the world. This is just a few examples of what we are doing in health care to fight COVID and other respiratory illnesses. I might add that the government does recognize the critical role, a world-class respiratory home care company like Lincare provides during a crisis like this.

Please turn to Slide 3. We have talked about the resiliency of our business for years. Our Q1 results and full year outlook should give you further proof of that resiliency. What is it that makes us so resilient? First of all, our commercial terms and conditions guarantee us a steady stream of cash flow. We serve diversified end markets, including health care, food, beverage and electronics. These markets are more defensive, but also offer nice opportunities for growth. Our business is local. We source, produce and sell our products locally. We are not directly impacted by supply chain disruptions. And because we operate our businesses locally, we know exactly how to align our cost structure with the market realities on the ground. The \$9.5 billion of projects in our backlog are all under contract and protected by terms and conditions that lock in a significant portion of our expected return. For example, our date-certain provision guarantees that we will receive our take-or-pay when we are ready to supply our product as opposed to when the customer is ready to take the product. Do we expect to see some slippage of scheduled? Yes, but no cancellations. That would be way too expensive for our customers. Who are the customers of these projects, you may ask. They are blue chip companies you know well, like Samsung, TSMC, ExxonMobil, Shell, BASF and Phillips 66.

Obviously, no one really knows what this recovery will look like. What I do know is we have a very resilient business model operated by a highly capable, experienced and dedicated global team. If the financial crisis of 2009 is any guide, we held EPS flat ex the effects of currency. And we doubled our free cash flow. And though volumes were down double digits, pricing was positive. We also raised our dividend, just as we have done now for 27 straight years. And we have no intention of ending that streak now.

We do have growth opportunities, both during and on the other side of this crisis. I have already mentioned a few in the health care space. I expect electronics to remain strong, particularly semiconductors, driven by the demand for IT infrastructure as our economy shifts more towards virtual work, the growth of artificial intelligence, and the rollout of 5G communications. We will be starting up our project backlog over the next several years. And we expect to see continued growth from merger synergies. I talked about this in our last call. It is leveraging the joint capabilities of our 2 companies across a larger global footprint. That includes applications, particularly in more resilient end markets an A to Z portfolio of product line plants and the opportunity to further optimize each plant size from a total cost of ownership standpoint.

I also expect to see more acquisition opportunities like decaps. But we have to be selective here. I have no interest in being the lender of last resort. But the most exciting opportunities will come as the world drives towards a lower carbon future, especially green hydrogen for mobility. I expect this alone to become a multibillion-dollar business for Linde. I have said before that I wouldn't trade places with anybody. That has never been more true than it is today. It's a privilege to lead this company and this team. I will now turn it over to Matt to discuss Q1 results and outlook.

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**Matthew J. White** - Linde plc - Executive VP & CFO

Thanks, Steve, and good morning, everyone. The consolidated first quarter results can be found on Slide 4. Sales of \$6.7 billion decreased 5% sequentially and 3% from prior year quarter. Excluding foreign currency translation and cost pass-thru, underlying sales fell 3% sequentially but increased 1% over prior year. Volumes fell 4% sequentially, which includes 2% from engineering timing and 1% from COVID impact. The remaining sequential volume decrease of 1% is mostly seasonal from Chinese New Year and Australian LPG sales.

Year-over-year volumes declined 1% due to the impact from COVID. Excluding that, higher growth from project start-ups and resilient end markets were mostly offset by engineering timing and prior year sales of equipment. We achieved pricing improvements across both periods and anticipate continued positive momentum from a combination of past and future actions. Operating profit of \$1.4 billion was flat with the fourth quarter but



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increased 11% over prior year. Even with multiple headwinds of COVID, foreign currency translation and economic weakness, we managed to grow operating profit double-digit percent from prior year. Furthermore, we held this profit equal to the fourth quarter, despite these issues and significant seasonal factors, especially in the APAC segment.

Operating margins of 20.1% improved 240 basis points from prior year and 110 basis points from the fourth quarter. Price and productivity efforts continue to support improvements in business quality despite weaker volumes. As Steve mentioned, we have a very resilient business model, which will serve us well in this uncertain environment. Net income growth was less than operating profit growth, primarily due to lower equity income this quarter. Both equity income and interest expense were unfavorably impacted by foreign currency revaluation of unhedged intercompany loans. While these revaluations had no cash impact, they did affect accounting earnings by approximately \$14 million of interest expense and \$12 million of lower equity income or roughly \$0.04 less of EPS. Earnings per share of \$1.89 is flat with the fourth quarter and 12% above prior year. Total COVID impact is approximately \$0.05, with roughly half from China and the remainder spread across the world. For the first quarter, most countries include a few weeks of COVID impact, whereas our Chinese operations have substantially recovered. In addition, first quarter reflects approximately \$0.09 of unfavorable noncash currency impact versus prior year from a combination of earnings translation and the unhedged intercompany loans. Therefore, underlying earnings growth was quite strong, which is further validated by our cash flow trends.

Operating cash flow of \$1.3 billion was 26% above last year. Recall that first quarter tends to be our weakest due to seasonality. So the year-over-year performance is more relevant. This improvement was driven by a combination of factors, including earnings growth, improved working capital and lower restructuring and merger-related costs. Also, it's important to highlight that this figure is true operating cash flow, not an adjusted figure, excluding working capital or other cash items. In this environment, it's more important than ever to manage all elements of cash. CapEx of just over \$800 million is roughly split between base and project CapEx. As a reminder, project CapEx represents capital spend directly attributed to the sale of gas project backlog. This backlog comprises new growth projects contractually secured by long-term fixed payments and terms and conditions that protect expected returns. Conversely, base CapEx represents all other capital spending, including maintenance, cost reduction, and growth initiatives that are either below \$5 million or not secured by a fixed payment contract. Base CapEx has declined almost 20%, and we anticipate lower spending the remainder of 2020, which will further support free cash flow.

Finally, return on capital continues to improve, now exceeding 12%. Recall, this metric was 10.4% a year ago. So this is a substantial improvement in a short period as we continue to find ways to maximize profit and cash growth while prudently managing the capital base. Given the importance of cash and capital structure, I'd like to spend a little more time on the details, which you'll find on Slide 5. The left side of this slide provides our operating cash flow trends since the merger date in the first quarter of 2019. Recall that the first 2 quarters of 2019 had more merger-related cash outflows in addition to less impact from cost synergies. Overall, you see a growing trend of improving cash from operations, especially when considering the inherent seasonality. Beneath operating cash flow, we are subtracting base CapEx. Base CapEx is the normal day-to-day CapEx for operations and small growth initiatives and thus supports the current earnings base. Project CapEx is excluded because it has more acquisition-like tendencies with defined windows of spending for specific customer contracts. Per the Linde definition of project backlog, all projects support incremental growth from secured fixed-payment contracts. We have a high degree of confidence in project returns, and we'll readily invest in them when we can. Therefore, we shouldn't penalize free cash flow with contractually secured growth. So a more relevant metric, it's called available operating cash flow or AOCF.

AOCF represents the cash we have left over to spend on specific growth initiatives or to distribute back to shareholders. You can see this is a substantial amount of cash, recently around \$1 billion to \$1.5 billion per quarter. Clearly, available operating cash is more than enough to cover the current dividend. In fact, this is what provides so much confidence in our ability to extend the streak of 27 straight years of annual dividend increases. Even after paying dividends, we have significant cash left over, and fully expect that trend going forward. We'll continue to prudently and responsibly allocate that excess cash toward attractive growth opportunities that meet our risk profile, including our existing \$4 billion sale of gas project backlog. And while we purchased 10 million shares of Linde stock in the first quarter, we have temporarily paused the program to reassess the growth opportunities in light of the current environment. While certain customers are restraining future investments, new growth opportunities are emerging in other areas including customer decaps, tuck-in acquisitions and hydrogen initiatives.

In addition to stable and growing cash generation, we have a high-quality capital structure, with some details provided in the upper right section of the slide. At the end of the first quarter, we had \$4 billion of cash. Furthermore, our trailing net debt-to-EBITDA ratio stood at 1.5x. As a single-A-rated company, we continue to have access to low-cost liquidity through Tier 1 commercial paper, which is backstopped by an undrawn credit facility



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of \$5 billion. Therefore, it's clear that Linde has a very high-quality balance sheet which will only strengthen from the growing resilient cash flow. This combination will enable us to quickly seize upon any new growth opportunities that emerge during these turbulent times.

I'll wrap things up with the 2020 full year outlook on Slide 6. It's safe to state that no one knows how the economy will recover from COVID or what a recovery would even look like. However, we remain confident that Linde has a resilient business model in any macroeconomic environment, including today. To address this dichotomy, we felt the best approach was to provide a scenario-based outlook for the full year 2020. The left side shows the prior 2020 full year guidance of 9% to 12% EPS growth from 2019 or 10% to 13% when excluding an assumed 1% currency translation headwind. You can see at the top that we are updating the currency translation impact to a 4% to 5% headwind. This estimate is based on the weighted average exposure of foreign currencies and the forward rates at a certain point in time. As you all know, this is a noncash impact and will change with the daily rates, but it represents our latest estimate.

2020 EPS growth rates excluding foreign currency will depend on both the definition and trajectory of a recovery. For simplicity sake, we are defining recovery as a point when base volumes are down low-to-mid single digit percent from 2019 levels. In other words, consistent with our February 2020 guidance, we believe that industrial production levels will experience recessionary conditions even when excluding direct COVID impact.

Regarding the COVID effect, we are providing 2 different scenarios of 2020 recovery. To reiterate, we are not trying to project the timing of a COVID recovery, but rather are providing 2 different benchmarks of potential underlying earnings impact. Clearly, there are a myriad of paths this could take, but the idea is that investors have a baseline to work with and then utilize their own projections to understand sensitivities. Scenario 1 assumes base volumes recover by early Q3 and then stabilize for the remainder of the year at levels which are low-to-mid single digit percent below 2019. Under this scenario, we would anticipate full year EPS excluding currency to increase mid-to-high single digit percent from 2019.

Scenario 2 assumes base volumes don't recover until mid Q4. This essentially means Q2 lockdown effects would carry until the middle of Q4. Here versus 2019, EPS excluding FX would be flat to negative low single digit percent. Under all scenarios, we are assuming Q2 to be the worst quarter with the most significant impact from COVID. At this stage, we would approximate the sequential EPS decline from Q1 to Q2 could be anywhere from 10% to 15% depending on the severity of lockdowns and impact of foreign currency translation. This is our latest estimate based on April results and our current thinking on the remainder of the quarter.

Finally, the CapEx outlook has been reduced by \$400 million, as we see lower base CapEx spending from merger efficiencies and fewer requirements for small growth investments. These actions further support our confidence in growing free cash flow over 2019. In summary, Linde offers an incredibly defensive model with significant internal productivity opportunities, a track record of growing free cash flow, a high-quality balance sheet and more than 65% of sales underpinned by fixed fees or resilient end-markets. This defensive model is further enhanced with significant profitable growth opportunities from our industry-leading project backlog, unrivaled hydrogen portfolio and world-class technical and engineering capabilities. It's true that we're facing an unprecedented pandemic and subsequent economic retrenchment that could limit global growth for many months or years. However, we remain confident in our ability to provide products and services to make the world more productive and safer while continuing to drive the organization to higher levels of performance and efficiency. I'd now like to turn the call over to Q&A.

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Your first question comes from the line of David Begleiter with Deutsche Bank.

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

Guys, just on decremental margins, how should we think about those in Q2 by segment, by region?



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**Stephen F. Angel** - *Linde plc - CEO & Director*

Well, I think if you look at it from a -- just looking at it from a volume standpoint, from Q1 to Q2, we see volumes dropping, say, low double digits. And that is what is the basis behind Matt's forecast that we should be off somewhere between 10% and 15% in Q2. So on an operating margin basis, I'm sure there will be some deterioration in Q2 because the volumes are just falling so fast and our ability to get cost out that quickly is not going to be there. Though for the year, I firmly believe we're going to grow operating margins because we'll be able to take out enough fixed cost to make sure that, that happens.

**Matthew J. White** - *Linde plc - Executive VP & CFO*

Yes. And I'll just add, David, to Steve's exact point. As you could imagine, with the local markets, we have a lot of costs and flexibility. So as we adjust those markets to the realities, the second quarter may not reflect the full cost benefit, but you may see some volume reduction, but then we'll get the benefit of adjusting those markets for the remainder of the year in terms of the cost structure.

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

And Matt, just on those FX impacts impacting equity income, earnings and interest expense in Q1, will they continue into Q2 as well?

**Matthew J. White** - *Linde plc - Executive VP & CFO*

So yes to separate that, the unhedged intercompany loan, generally, I would not anticipate that. What that is, it's based on a balance sheet date. So that's the end of the -- in this case, the end of the month of March. Those currencies have actually already started to appreciate vis-à-vis the dollar. So if anything, if those trends continue, it might even be a little favorable in Q2. We'll have to see. But this is, again, a noncash thing. It actually is just how we finance our various companies and where the functional currency is different than currency we use to finance them. So yes, I would not expect anything to that magnitude going forward, and it probably may even be a little bit positive depending upon where currencies go.

**Operator**

Your next question comes from the line of Peter Clark with SocGen.

**Peter Anthony John Clark** - *Societe Generale Cross Asset Research - Senior Analyst, Chemicals*

I've got 2. The first question now (technical difficulty) intrigued to see electronics, you have that down as resilient. I think the (technical difficulty) obviously some started up first phase. I think something in China as well, GTA. Wondering how much carrier gases is as percentage of your electronics business?

**Juan Pelaez** - *Linde plc - Head of IR*

Peter?

**Peter Anthony John Clark** - *Societe Generale Cross Asset Research - Senior Analyst, Chemicals*

Yes? Can you hear me?



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**Stephen F. Angel** - *Linde plc - CEO & Director*

Peter, sorry. We can't hear you. You are cutting off.

**Peter Anthony John Clark** - *Societe Generale Cross Asset Research - Senior Analyst, Chemicals*

Okay. I'm saying on electronics, what percentage would be carrier gases with Samsung starting up and also GTA now? Because I see how it's all resilient. That's the first question. And the second question alluding on the productivity you see for the full year, obviously that was the biggest part of the Christmas tree diagram in presentation in February. I think it was 6% plus of EPS to report. I presume you -- we had at a pretty big number, even if you can't do some of the reductions you have planned for 2020? Those are the 2 questions.

**Stephen F. Angel** - *Linde plc - CEO & Director*

Yes. Well, electronics is shown as 9% of our sales based on 2019. That's going to grow as a percent of our total sales. As we start-up our backlog, the electronics backlog starting up the year, this is on-site, was nearly \$1 billion, right, at \$900 million. So as we start that up, we're going to get the benefit of those sales. So a large piece of the electronics is on-site and large piece of the growth will come from on-site, again, as we start-up these projects. As we look at -- and I always look at total cash fixed cost. And so what does that mean? That's all fixed cost, minus depreciation. So all the controllable cash cost. And we've gone through multiple planning scenarios. But where I'm confident we're going to end up for the year is that our total cash fixed cost in 2020 will be lower than 2019 by something in the order of high single digits, so minus high single-digit year-over-year comparison. That's higher than what we had planned coming into the year. But given, obviously, what's taking place where the economies have basically shut down in U.S. and Europe for a big part of -- or a piece of March and most of April and kind of unsure how we're going to emerge from this, we thought it was prudent to take those actions. And again, if you go back and listen to Matt's forecast, he's saying that recovery to us. Again, we're talking 2020. So we're acting as if nothing happens going beyond 2020, which obviously, there will be. But by the end of 2020, we're saying that the recovery is still below pre COVID levels. That's just an assumption, and it's low single digits to mid-single-digit lower recovery point. Obviously, if the recovery is stronger, we're going to participate in that, and we're going to capitalize on that.

**Operator**

Your next question comes from the line of Bob Koort with Goldman Sachs.

**Robert Andrew Koort** - *Goldman Sachs Group Inc., Research Division - MD*

Could you guys talk -- I think you noted in your comments maybe some opportunity for decaps. Are you seeing greater interest in your customers or potential customers doing that in light of pressured economic conditions or maybe crack spreads or something else? Or has there not been much change and companies really haven't had a chance to go out there and solicit or consider interest in doing that?

**Stephen F. Angel** - *Linde plc - CEO & Director*

It's a good question, Bob. That was something we commented on. The answer is yes. We are seeing more interest. I think more will come as they think through their financial condition. We're working on something as we speak. But I do expect that one of the opportunities that's going to emerge from this is the opportunity to do some of these decaps. Now obviously, we have to be careful, we have to be selective, we have to make sure that these are world-class assets that we're going to be supplying operated by blue-chip companies. But I certainly expect to see more opportunities than we had in prior years.



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**Robert Andrew Koort** - Goldman Sachs Group Inc., Research Division - MD

And one other thing I note, Steve, across sort of the large-cap more defensive chemical names we look at, at least, you guys have probably had the most resilient earnings stream even in light of your scenario analysis, but maybe haven't been reported as much from an equity standpoint. I'm curious on 2 things. One, you guys have daily sales runs across your network. Years ago, you used to provide us monthly updates. Is there any scope that maybe you could give us some interim quarter updates on whether scenario 1 or 2 might be occurring or your expectations for it? And then two, I'm wondering, is there any chance as that progresses, you could become more ambitious on getting back into the share repurchase activity?

**Stephen F. Angel** - Linde plc - CEO & Director

All right. So let's -- so I'll take one. Yes, I do think we could probably think about some kind of interim outlook based on -- you are correct in your assumption that we look at these volumes very closely. I look at them. I try not to look at them daily, that's almost too much, but I certainly look at them on a weekly basis around the world. So yes, we do have an indication of where we're tracking. I think we can come up with something. As far as the share buybacks, I think at this point, given the opportunity slate we just talked about with these decaptivations, and some of them can be quite large. We want to make sure that we have capacity available to take advantage of that. If you go back, what we've said countless times is that the priority for our business is to invest in the base business. And we want to invest in core plants, core businesses, whether it's new projects or decaps. That's what provides the highest return on capital for our company, and that's always been our priority.

**Matthew J. White** - Linde plc - Executive VP & CFO

Bob, this is Matt. Maybe I could add a little to kind of your question on the outlook. Now obviously, we have April under our belt here. I'd say April came in better than what we initially anticipated. But if you look at our 10% to 15% outlook, I mean, the worst-case side of 15% would probably have to imply April repeats for the remainder of the quarter. Obviously, if there's an improvement from April, you could be at the 10% or better layer. But at this point, we'll have to see where that goes. But I think that's how we think about the sequential look, and it's very fluid. It's something that we have to keep monitoring. But that's how we think about looking forward.

**Operator**

Your next question comes from the line of John McNulty with BMO Capital Markets.

**John Patrick McNulty** - BMO Capital Markets Equity Research - Analyst

When we look at the project CapEx that you laid out, is there a way to think about what portion of that's tied to the smaller projects, the ones that are sub \$5 million? And how should we think about the returns on those, whether they're kind of in-line with the general return profile of the larger ones or are they above or they below? How should we think about that?

**Stephen F. Angel** - Linde plc - CEO & Director

Well, I think to Matt's point, most of the degradation and reduction of \$400 million or so is in the base side. With respect to large projects, obviously, those returns are locked in. It's a question of, do we slide a couple of months from anticipated start up? The base has everything in it. So it has maintenance. It has safety. It has small projects, everything. But large project falls into the base category. I don't anticipate -- I have approved a couple of projects here recently. So it's not like the world came to a total end. And so there are pockets of opportunities, small on-sites that we continue to see that are very good projects. Nothing has changed in the return profile. So there's still good returns. But it stands the reason that we're going to see less of those in this economy.





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**Matthew J. White** - Linde plc - Executive VP & CFO

And John, just to add to that. As you know, a material portion of the base CapEx was related to growth. And within the growth, I'd put it almost the 2 basic buckets. There's exactly what you're referring to, these small standard plants under \$5 million. To Steve's point, we're still seeing opportunities. We're still seeing growth. So that's an area that -- it will be slower, but it's happening. But also the other part of that growth would be tanks, cylinders, trailers, a lot of the transportation and storage equipment that relates to growing either liquids or cylinders. That's an area we would anticipate in this environment to be less, because we will be able to have a current large asset base that we can already utilize. So I would anticipate even more decline in what I'd call transportation and storage components of growth than probably some of these small on-sites.

**John Patrick McNulty** - BMO Capital Markets Equity Research - Analyst

Got it. That's helpful. And then maybe just as a follow-up. So you commented in the beginning remarks around Lincare and the opportunities there and the support that you're giving. And one point that you made was that the government truly appreciates this. I guess, can you flush that out a little bit? I know this has been kind of a business that maybe there were question marks in terms of whether it's fit in the portfolio or not. I guess, how might that be evolving at this point?

**Stephen F. Angel** - Linde plc - CEO & Director

So this is a business -- Lincare is a business that reports directly to me, and it has since the beginning of the merger. And coming into the merger, I was looking at it very carefully, and I felt that the trend line coming out of '18 was starting to turn up a bit. And in '19, the results that were delivered were better than '18. And coming into this year, as we were building up the plan, we felt '20 would be better than '19. And as I sit here today, given all that's going on with respect to COVID, I'm very confident that we're going to have a solid year in Lincare. And what I really mean about the appreciation side, if you -- we've all been listening to the news, trying to flatten the curve with the health care system so it's not overwhelmed. Part of that is they need ventilators, they need IC beds. And what we do from a home care standpoint -- it's a respiratory home care business. So we can provide a lot of these products, a lot of these services, and we're there to take the patients coming out of the hospital to relieve the hospital of that pressure on capacity and treat those patients in a home environment.

So that's something that the government, the Center for Medicaid -- Medicare & Medicaid Services recognized early on to their credit, and they have been working with us to facilitate the transition of patients to make sure that the documentation and paperwork is not getting in the way, to relieve the requirements for face-to-face transactions, which has been something that they've required historically because they know that doesn't make sense in this kind of environment. So our ability to really step up and provide a needed service in a critical time for our country is there. And Lincare has been able to step up and do that. It would be hard for a lot of smaller home care companies do that because they just don't have the capacity. They don't have the ability to flex. They don't have the resources. They don't have the complete repertoire of equipment and clinicians and technicians and all that. But that is what Lincare brings to the equation and at an important time. So clearly, they have demonstrated their value and are demonstrating their value to me and to the company this year. And I think going forward, that's likely to be the case. Again, COVID-19 is a respiratory illness, and that is our specialty, respiratory care. So I'm certainly feeling much more positive about this business. And I think I said that in the beginning that I wanted to spend some time to look at it, to understand it, see if we can improve it, what the outlook is. And it's pretty positive today.

**Operator**

Your next question comes from the line of Vincent Andrews with Morgan Stanley.

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

Steve, maybe we could just talk a little bit more about the decaps. And I guess maybe the angle I'm thinking about is just -- I assume just like large projects, there's going to be competition for decap. So maybe just talk about where you think your edge is. I assume some of it has to do with



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density, some of it has to do with engineering. But how do you think the winner of these decaps is going to be decided? And from your own perspective, how do you think about hurdle rates, risk profiles versus a similar dollar amount for a large project that might be out there?

**Stephen F. Angel** - *Linde plc - CEO & Director*

Well, I'm not going to think about hurdle rates any different, and I'm not going to think about risk any difficult going into this. I think there will be cases where there is competition. There will be cases where we will be a supplier in a complex and we would be the natural partner to decap an existing asset, and it will just be a negotiation between 2 parties. And I think the same is going to be true for our competitors. Clearly -- so where that's the case, that's where the opportunities will come. Clearly, Linde Engineering has built a lot of plants all over the world, both ASUs and HyCO plants. And we have that list, and so we know exactly where they are. And we'll go through that screen to determine which ones we're interested in and which ones we're not.

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

And maybe just as a follow-up on your leverage level. I know we've been having this conversation in prior quarters, but obviously, the world is a bit different now. So has anything changed about your willingness to lever up the company? And does it matter whether it's a decap to cash flow right away versus large projects with buybacks?

**Matthew J. White** - *Linde plc - Executive VP & CFO*

Vince, it's Matt. Yes, I start with the standard basic part of our capital allocation policy, which we're going to maintain an A rating, right? We're absolutely committed to that. And the nice thing, I think, about the capital policy we've laid out is it's going to be the same throughout any environment, and this is no different. So as you may recall, our approach is maintain the A rating. We want to raise the dividend every year. And our priority always, always, always is good growth projects that meet our criteria. Whatever is left over goes to buybacks. And to the points we made in the prepared remarks and Steve's points, we are seeing a different landscape of growth opportunities now in light of this environment. We want to understand that and assess that. Hence, we've paused the buyback program. Now that the potential growth opportunities are changed, and some, especially things like decaps, will have more different cash profiles than you would on normal projects, we just want to assess it and understand it. So our capital allocation policy has not changed at all. Our view on the desired credit rating and appropriate debt levels has not changed at all. But this environment has created opportunities where -- that did not exist prior, and we want to make sure we assess that and understand that.

**Operator**

Your next question comes from the line of Mike Sison with Wells Fargo.

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

In terms of Q1, just sort of curiosity, the adjusted EBIT was up 11% and -- no, I'm sorry. Yes, adjusted EBIT was up, operating income was up 11%, yet EBITDA was only up 4%. Can you sort of walk through the difference there and how that will flush through for the remainder of the year?

**Matthew J. White** - *Linde plc - Executive VP & CFO*

Yes. Mike, this is Matt. I'd be glad to answer that. You may recall in the second quarter of 2019, when we had this call, I had discussed the sequential Q1 to Q2 EBITDA walk and we had had a presentation -- a format change. As you may recall, we didn't officially merge till March 1, 2019. So there was a presentation format change that was prospective going forward the same, but on the year-over-year this effect is happening. So simple answer is, there's probably around 4% or so of other reclasses. It was just a line swap between fixed cost and EBIT or D&A. So it's a 0 net effect



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operating income, but it's a line swap between fixed cost and D&A. So that's probably another 4% or so. In addition, I discussed the equity income impact we had on the noncash unhedged loans. As you know, EBITDA, the calculation has equity income in it. So that's probably another percent or so; again, noncash, but just an impact. So you're probably really -- on that basis, EBITDA would maybe be 9% or so. And the only difference then between the 11% is depreciation is a little lower. But I would just say, most people use EBITDA as a proxy for cash. And I think it's better just to look at cash. And operating cash flow was up 26%. So from my perspective, I'm less concerned about some of these pocket switches and EBITDA effects, and I'm much more interested in what's the operating cash flow trend. But going forward, you won't have this effect anymore. As I mentioned, that was a onetime thing in Q1 upon the merger adoption. So I'm not -- no concerns going forward.

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

Great. And as a quick follow-up, last quarter you had a nice EPS waterfall chart. When you think about the positives, the savings, like 6% or so, then pricing was a couple percent. Stock buyback was couple percent. Maybe that's a little bit lower and then project backlog was couple percent. Are those positives still, sort of intact? And I guess that implies something like mid-single-digit declines in your base case for demand and then maybe 10, 11, 12 who knows in the bear case. Is that kind of the way to think about it?

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**Stephen F. Angel** - Linde plc - CEO & Director

Well, I think approaching the elements is the right way to do it. And the project backlog, we've said it looks like 2% top line, bottom line growth, this year, next year, the following year. And I think that's close enough. Pricing, I think if you go back and look at the last -- the Christmas tree chart we all call it now, but it looked to be around 2%. I see nothing that's going to change in my view of that. And if you go back and look at us historically too, even when volumes plummeted, we're always able to get positive pricing. So I don't see that changing. The cost side will be higher. We'll get more cost out this year because that's the environment that we're in, and that's what we need to do. The big difference -- so the 2 big differences are FX, which Matt talked about. And then if you take FX away, then it's volume. And so everything hinges on volume. And so we laid out 2 scenarios for you. You can come up with your own scenarios. Whatever we laid out probably won't be correct because if you go back and look at what we understand about this disease, I think, clearly today, it's different than what we thought about it 30 days ago. So this thing will continue to evolve. And again, if the volumes come back faster, if we're rocketing into next year, we'll do exceptionally well.

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**Matthew J. White** - Linde plc - Executive VP & CFO

Yes. And the only thing I'd add to Steve's point, a lot of people throw the word recovery around. And I just ask that -- ask them what recovery means? Because recovery means something different to everybody. No one knows what it will be, but we did our best effort to define it. We define it as actually some recessionary conditions. So I think that's an important thing too, is what even is a recovery and then when do we expect it?

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**Operator**

Your next question comes from the line of Nicola Tang with Exane BNP.

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**Nicola Tang** - Exane BNP Paribas, Research Division - Analyst

Actually, it ties on quite nicely to that point you just made on recovery. I think in your opening remarks, you mentioned that actually you had seen a decent recovery in China. So I was just wondering if you could talk about how China today is tracking versus more normal conditions? And then just on the engineering business. In the slides, you mentioned that the sales decline was driven by project timing. I was wondering, to what extent that was due to disruptions related to coronavirus not being able to get on-site versus like longer-term project delays?



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**Stephen F. Angel** - Linde plc - CEO & Director

Okay. So let me take -- I'll start with China. Looking at the volumes today, coming out of April, it looks like merchant liquids in the high 80s, probably tracking 90% now. Not back to 100% pre-COVID levels yet, but obviously, the trend is more positive. The issue in Asia now is that it's the same problem that we had in Q1 in China is now Q2 in places like India, Southeast Asia, to a lesser extent, Australia. The on site business, Tier 1 steel suppliers took a lot of oxygen throughout the downturn, throughout Lunar New Year, throughout COVID. I think the -- what we have to watch for now going forward in this year is that we're not building a lot of inventory, that it is going to get absorbed. But it's a good time to be partnering with Tier 1 suppliers in China. The chemical side of the house, it kind of ranges. I'm looking at numbers from 70% to 90% of pre-COVID levels. And some of that's going to depend quite frankly on how quickly China recovers economically and the export order book will drive the chemical side of the house. But clearly, it's come out of this COVID period as everyone has been reporting that you've listened to, and that continues.

On Linde Engineering, obviously, there are some challenges executing projects. I would say nothing substantial at this point. The whole virtual management that they embarked on, just like we did here and many other companies have done, has worked pretty well. So in terms of project delays and things like that, I haven't really seen it yet. And everything seems to be tracking. It wouldn't surprise me if sales do slip a bit. But the order backlog is firm, and that's the most important thing at this point.

**Operator**

Your next question comes from the line of Duffy Fischer with Barclays.

**Patrick Duffy Fischer** - Barclays Bank PLC, Research Division - Director & Senior Chemical Analyst

Steve, you had referenced kind of the recession of 2008, 2009 and how well the business did through that, both EPS and pricing. Looking back at that versus what we're seeing today, what are the pros and cons of using that as a template, as a guide as we go through? So for the merchant business, what might that mean? And then because you didn't have the engineering business back then, maybe walk us through what that business could look like in a recession in your mind?

**Stephen F. Angel** - Linde plc - CEO & Director

Yes. I didn't have Linde Engineering business, but I also didn't -- I also -- I might have still had a small home care business in the U.S., but nothing on the order of Lincare. So you have some of those counter dynamics as well. Back then, volumes, I believe, in the U.S. dropped about 12%. I think worldwide, we were down about 10% for 2009 versus 2008. Again, pricing was positive. Very similar reactions. Pipeline volumes in the U.S. fell precipitously during the financial crisis. They went down pretty quick. We saw the same thing happen here with COVID. When you shut down your industrial base in the United States, you see pipeline volumes start to drop precipitously as well. Merchant liquid volumes fell a lot back in '09. They fell a lot looking at April here as well. So obviously, different crises, but the impact is very similar on volumes and where those volumes are affected. Again, I think Lincare is going to have a very good year, no doubt about that. As I look at Linde Engineering, the fortunate thing for Linde Engineering is we closed a very large order coming into this year. And their third-party backlog is \$5.5 billion. That's 2 full years of sales they have sitting there in the backlog. And in addition to that, they are doing the engineering work for the other \$4 billion or so of sale of gas. So they're in a much, much different position than perhaps they were historically, huge backlog, sale of gas plus third-party to absorb the engineering cost work. And I'm not worried about Linde Engineering this year for sure. And I think we'd have to get well into next year. And with an order outlook that says orders have really dried up before we would start to see some pressure on Linde Engineering, and then we'd have to go to working on some of the cost a little more aggressively. But today, they just have a big backlog they need to work off and execute, and that's going to sustain them for a while.

**Patrick Duffy Fischer** - Barclays Bank PLC, Research Division - Director & Senior Chemical Analyst

Great. And then just on your comments around decaps, the opportunity set SMRs versus ASU versus others. What does that look like in your mind over the next year or so?

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**Stephen F. Angel** - *Linde plc - CEO & Director*

I think that's an interesting question. I think, obvious -- I would say that we'll see both -- maybe a little heavier on the ASU side, but I think we're definitely going to see both types of opportunities. Obviously, if we're talking about SMRs, it's going to be hydrogen or syngas or CO for refining either in the U.S. or around the world -- other parts of the world. And then ASU, I think, would be -- those opportunities are going to come up. I'll just stop there.

**Operator**

Your next question comes from the line of Laurence Alexander with Jefferies.

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

So one of the debates after the merger was the cultural integration and the resilience of the 2 cultures and how well they would work in a crisis. Now that we're in one, can you give some perspective on both positives and also maybe just specifically addressed, have you -- needed to replace staff in the senior levels in any regions or product lines as part of the -- over the last 6 months? But also, can you address sort of just what you've been pleasantly surprised by or what's worked, what hasn't?

**Stephen F. Angel** - *Linde plc - CEO & Director*

Well, I think that's a good question. Obviously, we've been in the middle of this for a couple of months and even a year plus going back to the beginning of the merger. But I've been quite pleased, very satisfied with the response I've seen from everyone around the world, not to differentiate between legacy Linde or legacy Praxair or legacy BOC or legacy whatever because we have various groups in the new Linde plc. But -- because this isn't my first rodeo as soon as we started to see things unfolding the way they did, I basically went back and pulled the playbook out of 2009, took a good look at that, refreshed that, got that out to everybody. I think it's important that we all get grounded early in terms of what needs to be done, what pace it needs to be done. And I'm very pleased with the response that I have seen really from everybody around the world.

**Operator**

Your next question comes from the line of Steve Byrne with Bank of America.

**Steve Byrne** - *BofA Merrill Lynch, Research Division - Director of Equity Research*

A couple of months ago, Matt, you were talking about -- at the beginning of this pandemic as it was unfolding, you expected to learn how to be more productive, something to that extent. And I just wanted to see whether you were able to pull forward any of these productivity initiatives that we feel like, oh, maybe have been set at -- to relatively modest levels. Are you able to pull forward because of any disruption going on at the governments or workforce? Anything along those lines that we could expect greater cost synergies going forward?

**Matthew J. White** - *Linde plc - Executive VP & CFO*

Yes. And maybe to learn more productive, I'd maybe just say there's probably more productivity opportunities. I agree with that, absolutely, and I think the prior conversation we had. And I think it's, to an extent what Steve had said in his earlier remarks, that we're a very, very local business. And obviously, we have a set of opportunity of some efficiencies that we were already undertaking with the merger. In conjunction with that, as the dynamics change in our local businesses, we need to adjust and adapt with our cost structure. On top of that, when you get in an environment like this, there's just a bit more of a burning platform. And I think that burning platform helps -- even to Laurence's question earlier, it actually brings the culture together faster, in my opinion. And we're seeing that. And so I think you find more opportunities, people become more creative and

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the local markets require maybe cost structures that might be a little different. So you add all that together, yes, absolutely, there's greater productivity now than what we originally anticipated in the beginning of the year. And we just need to act on it in all capacities. And it's across all fronts. And it's not just people, it's lots of different things. And so I think this is what we are actively working on. And we feel there's a lot more opportunity that we're going to continue to work towards, and we should be seeing the benefits in our results throughout the year and into future years.

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**Stephen F. Angel** - *Linde plc - CEO & Director*

So I'm going to add one thing, then we'll take 1 more question, I think, Juan, right? So everybody is going to go through what are the implications of COVID, strategically speaking going forward? And what are the implications to your company, what are you going to do different? We've already alluded to a couple of things throughout this. Being a local business, not directly impacted by supply chain is good thing for our business. We've talked about the importance of health care, being in resilient end markets. We've talked about decarbonization opportunities, hydrogen. We're going to see that going forward. But another implication that I think relates to your question is digitalization and the ability to operate plants remotely, the ability to monitor plants remotely, the ability to diagnose what's taking place, preventative diagnostics, predictive maintenance. All of those capabilities are going to be even more important, not just for us but for other companies going forward. And that -- I've always viewed that as mainly a productivity opportunity for our company.

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**Operator**

Your final question comes from the line of PJ Juvekar with Citigroup.

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**Kara Enomoto**

This is Kara Enomoto on for PJ. I was just hoping you could possibly compare and contrast what you saw in China in Q1 with maybe the cadence of declines and a recovery in the Americas, EMEA and other parts of Asia. And while I know you can't get too granular, I was wondering if you're starting to see any positive or stabilizing signs in any of those regions?

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**Stephen F. Angel** - *Linde plc - CEO & Director*

Yes. I think China, obviously, hard stop and then reopening instant stimulus from the government. And clearly, they're coming out of this fairly quickly. I think for Europe, when I look at the merchant liquid volumes for Europe in April, just to give you that number, it's off 15%. But as I look at the industrial volumes, it looks to me like maybe the last week or 2 in April, we're starting to see a little improvement from that.

If I were to look at the United States, merchant liquid volumes are off like 20% sitting here today. I haven't seen any change week-to-week in that number. And if you think about it, China went first coming out, followed by Europe maybe starting to emerge from that, and then the U.S. is still kind of behind and more at the bottom of the curve at this point. So we'll see.

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**Operator**

Management, the floor is yours for any closing remarks.

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**Juan Pelaez** - *Linde plc - Head of IR*

Yes. Just thank you again for everyone participating in today's call. Like always, if you have any further questions, feel free to reach out to me directly. Have a great day and stay safe.

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## Operator

Thank you, ladies and gentlemen. This concludes today's conference call. Thank you for participating. You may now disconnect.

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