

Mexichem S.A.B. de C.V.  
Second Quarter 2016 Earnings Results Call  
July 28, 2016 at 11:00 a.m. Eastern

**CORPORATE PARTICIPANTS**

**Antonio Carrillo Rule** – *Chief Executive Officer*

**Rodrigo Guzman** – *Chief Financial Officer*

## **PRESENTATION**

### **Operator**

Good morning, everyone, and welcome to the Mexichem Second Quarter 2016 Results conference call. Following today's presentation, there will be a question and answer session. During this conference call, management will make forward-looking statements to assist you in understanding its expectations for future performance. These statements are subject to a number of risks that could cause actual events and results to differ materially. Please refer to the company's filings with the Mexican Stock Exchange for full details of those risks.

In addition, statements during this call, including statements relating to the market conditions and future performance, are based on management's view as of today, and it is anticipated that future developments may cause these views to change. Please consider the information presented in this light. The company may, at some point, elect to update the forward-looking statements made today, but specifically disclaims any obligation to do so.

Please note that today's call cannot be reproduced in whole or in part without the explicit consent of Mexichem. Please note also that this conference is being recorded.

I will now turn the call over to Ms. Berenice Muñoz, Director of Investor Relations. Please go ahead.

### **Berenice Munoz**

Thank you, operator. Good morning, and welcome to our conference call. We are pleased to be here today to present our second quarter 2016 results. We appreciate your time and participation in this conference call. Our speakers today will be Mr. Antonio Carrillo Rule, CEO, and Mr. Rodrigo Guzman, CFO, and I will now turn the call over to Antonio for opening comments.

### **Antonio Carrillo Rule**

Thank you, Berenice. Good morning, everyone, and thank you for joining us today to review Mexichem's second quarter results and to discuss our business outlook.

Before reviewing the financial and operating highlights of the quarter, I would like to take a moment to update you on the current status of PMV after the tragic accident that occurred there in April. Let me start with the human side of the accident. The joint venture has indemnified all the families of the victims and those injured. Also, we continue providing psychological support to family members and employees of the different entities involved.

On the investigation into the cause of the accident, I am pleased to report that the government investigators have finished their work, and we are waiting for the final report to be issued. This process took longer than we expected and, therefore, postponed the start of the private investigation that is being carried out by the independent expert that PMV hired, and the investigation being done by the insurance company. However, now that the government investigation is completed, we are making solid progress.

Since we have not received the full report on the cause of the accident, we have not recognized the benefits of the insurance in our financial statement. As I mentioned during the last conference call, there is generally a mismatch between the time you recognize the impact of the accident and the time you recognize the insurance benefit. In accordance with IFRA's accounting rules, we took a \$286 million write-off in the second quarter, of which \$244 million was a non-cash charge representing the asset value of the VCM plant. \$5.6 million was cashed out in the second quarter, and the remaining

\$36.4 million is expected to be cashed out in the following months.

This amount relates mostly to payments to suppliers, indemnities, legal advisors, and other expenses. Once the investigation is finished, we will finalize the claim and recognize the insurance benefits, which, as we have mentioned before, covers the asset value of the plant at current replacement costs, business interruption, and third party liability expenses.

On the environmental side, all the information we have as of today tells us that there was no relevant environmental impact. There was a cloud coming from the explosion and subsequent fire, and the authorities requested that an environmental impact study be conducted to analyze the soil and water samples in the areas surrounding the plant. This study is on the way, and we should have results in the next couple of months. With that information, we will determine if there's any remediation that needs to take place.

On the business side, the Mexichem team has done an incredible job to minimize the impact of the accident on the raw materials supply, by sourcing enough VCM to cover our needs for the rest of the year. As I mentioned during the first quarter results conference call, we expected that the second quarter would have an impact in our EBITDA in the resin business of roughly \$10 million, due to the expected lack of VCM for our production of PVC. I am very pleased to announce that we were able to mitigate most of this EBITDA impact.

Also, the team that we have put together to deal with the insurance on a full-time basis has done a tremendous job in managing a very complex situation, and making sure that all the details are handled in the most efficient way possible. I would also stress that the cooperation with our partner Pemex has been very important in bringing the situation to where we are today.

Now, let me talk about the other 98% of Mexichem. I am pleased to report that our operating results in the second quarter were in line with our expectations, and have put us on track to achieve the post-accident EBITDA guidance that we provided last quarter of around \$900 million, excluding the one-time effect in PMV. We succeeded in maintaining adjusted EBITDA levels that were basically flat with last year, despite several headwinds, including the revaluation of the US dollar against almost all Latin American and European currencies, softening demand in Brazil and Ecuador due to difficult economic situations, lower selling prices for PVC, and a significant reduction in operations in PVM which caused us to lose 70,000 tons of VCM for PVC production. We were able to overcome this impact and, in fact, post higher adjusted EBITDA margins across all of our operating units, thanks in large part to a greater contribution for higher-margin specialty products, successful progress to expand and diversify our end markets, and reconfiguring those [indiscernible] or businesses that generated losses. We expect these actions, combined with our ongoing vertical integration, to further lower our input costs, and guarantee supply to continue, to build Mexichem's resilience in times of challenging market conditions, and to enable us to steadily expand profitability over the long run.

For example, in the second quarter, we were able to utilize the commercial flexibility in specialty products in the Resins, Compounds & Derivatives business unit to take advantage of higher demand and better pricing in European markets.

Our Flour business gained traction with cement industry customers, who accounted for 29% of our metallurgical fluorspar sales in the second quarter, up significantly from last year. And this same end market diversification is taking place in our Fluent Group, where our pipe posts are being marketed successfully to the datacom industry, to mitigate the fall off in demand from US energy markets.

In the second quarter, we continue to strengthen our balance sheet. Our cash position at the end of the

second quarter increased both year-on-year and sequentially, and we continue to have great working capital management. Our trailing twelve months adjusted EBITDA to net debt ratio was the lowest we have had in the last seven quarters, and capital expenditures declined as we approached the end of our ethylene cracker project.

Finally, we continue to focus management's attention into improving Mexichem's returns. I am seeing positive signs that this very important cultural change is gaining traction. We have made significant progress in reducing losses in some of the businesses, and also saw significant progress in increasing net income margins in other parts of the company.

Now, I will turn over the call to Rodrigo Guzman, our CFO, to provide additional financial details of our second quarter performance. Rodrigo.

### **Rodrigo Guzman**

Thank you, Antonio, and thank you all for joining us today.

First of all, as one the leaders of this team we have put together to deal with the incident, I want to recognize them for the commitment and professionalism they have demonstrated in this very challenging period. Also, I want to highlight the cooperation and support in this process from our partner Pemex.

The one-time charges related to the accident at PMV's VCM plant that Antonio mentioned and that are detailed in our earnings release makes our second quarter and first half financial results difficult to compare to similar periods in 2015. Therefore, I will make my prepared remarks using financial metrics that are adjusted to exclude the one-time charges. But, of course, I am happy to respond to any questions that you may have related to our reported results.

This was another quarter in which we continued to show our ability to drive up organic growth in some business units, improve profitability and expand our specialty resins product. In the quarter, we face significant pricing pressure across a range of products, which reduced revenues, despite volume growth in our business [indiscernible]. We also faced significant currency headwinds and tougher comparisons versus last year, resulting from the US dollar revaluation that took place through 2015, but specifically in the second half.

In the second quarter and the first half of 2016, this currency impact reduced our reported revenues by \$45 million and \$167 million respectively. However, as I will highlight later, we continue to produce stable EBITDA and improved EBITDA margins across the company. And we expect that some of these headwinds we experienced in the first half of the year will not be present in the second half.

Our second quarter 2016 revenues totaled \$1.4 billion, representing a year-on-year decline of 6%. This was mainly the result of the negative currency impact I mentioned above, a decline in the price of PVC resins, and weaker demand from Latin America, specifically in Ecuador and Brazil, together with our reduction in the operations at PMV. On a constant-currency basis, our revenues declined 3%.

In our Vinyl Business Group, revenues totaled \$500 million, down 11% from the \$559 million reported in the second quarter of 2015. This was mainly the result of the PMV impact and flat volumes paired with a decline in selling price. Despite a 9% decline in revenues from our Resins, Compounds & Derivatives business, volume increased by 4%, driven by strong demand in our European specialty resins business.

In our Fluent business, revenues were \$798 million, representing a 4% decrease. The impact of

currency fluctuation is higher in our Fluent business, compared with the other business groups. Fluent Latin America and Fluent USA reported sales decline of 11% and 5% respectively, with the former due to the revaluation of the US dollar against almost all Latin American currencies, and the reduction in demand in Ecuador and Brazil, and the latter due to the fall in demand from certain US energy market customers.

I would like to mention that Fluent Europe, our largest operating region for the business group, saw an increase in sales of 3% to \$373 million. On a constant-currency basis, total sales to Fluent will have increased 2% to \$843 million. In Fluent, we continue to improve our product mix as we shift to products with higher margins, which, together with the lower raw material costs, improved profitability.

Fluor Business Group sales declined 7% to \$165 million, on 100% increase in volumes. This was mainly the result of lower prices and product mix. As a result of our revenue-diversification programs, 29% of our mix part volumes came from cement sales this quarter.

Our geographical sales mix remains similar to the prior quarter, with North American representing 36% of total sales, of which the US accounted for 16%. Europe increased to 39% from 36%, with Germany representing 13%, and the UK 8%. In South America, where sales totaled 21%, Brazil represented 6%. Our adjusted EBITDA exposure to Brazil was 3%, and to the UK 7%.

Moving on to our profitability by business group, in Vinyl, adjusted EBITDA increased 15% to \$78 million, mainly caused by the declining production capacity of PMV, chlorine, and caustic soda plant, and the temporary shutdown of our ethylene plants. Our Resins, Compounds & Derivative business remained resilient, as EBITDA margin expanded 120 basis points to 15%.

In our Fluent Business Group, on a constant-currency basis, EBITDA increased 10%, totaling \$138 million. EBITDA margin also expanded in the business group by 156 basis points, to 16.3% from 14.8%.

In the Flour group, our EBITDA also remains steady, totaling \$66 million, and even in the face of pricing pressure, EBITDA margin expanded 337 basis points, to 40%.

Consolidated adjusted operating income totaled \$165 million, a decrease of 5%. This decline was a result of the factors I just mentioned. For the second quarter, financial costs decreased by 33%, to \$42 million. This was caused by a \$14 million loss we incurred during the second quarter in '15, which was tied to intercompany loans denominated in Euros, a position that was hedged in the fourth quarter of '15, and remained covered as of the end of the second quarter of this year.

Our current taxes, excluding the one-time PMV accident, increased by 13% while deferred tax increased by \$6 million, mainly as a consequence of the foreign exchange impact related to our debt in dollars, which increased our tax losses, but not our income before taxes, since our [indiscernible] currency is the dollar.

Net majority income increased 34% to \$86 million, representing an adjusted ROE and adjusted ROIC of 6.2% and 6.3% respectively.

Now, I will briefly cover our first-half 2016 results. Our reported revenues totaled \$2.7 billion, down from \$2.9 billion reported in the same period of last year. Adjusted EBITDA reached \$457 million, an increase of 2% from the first half of 2015, but adjusted EBITDA margin expanded to 17%. Our year-to-date adjusted operating income totaled \$274 million, up 4% from the same period a year ago. Finally, our adjusted net majority income was \$137 million, an increase of 65%. As you can see, when

excluding the one-time effect of the PMV charges, our year-to-date profitability remains strong.

In the first half of 2016, we maintained our status as a financially disciplined company. Operating cash flow before capital expenditures totaled \$174 million. Capital expenditures for the first half were \$233 million, \$25 million or 10% lower than a year ago, and in the second quarter, that declined by 12%, to \$123 million.

Of this year, \$53 million was invested in the ethylene cracker in Texas. \$19 million served as a carryover in PMV and \$51 million allocated to organic projects. As of June 30, 2016, Mexichem's equity investment in the ethylene cracker reached \$625 million, representing 83% of the total liquidity investment agreed upon with Oxychem.

Our trailing twelve months net to adjusted EBITDA ratio totaled 1.86 at the end of the first half, and our interest coverage is increased to 4.42 times.

I will now turn the call back over to Antonio for closing remarks. Thank you.

### **Antonio Carrillo Rule**

Thank you, Rodrigo.

First, let me start my forward-looking comments on a recent event that is in everyone's mind: Brexit. Our UK business represents around 8% of our revenue and 7% of our EBITDA. Each of our three businesses has operations there. In the case of Fluor, we are making small adjustments to our business model in Europe, and do not expect any impact from this event. In the case of our compounding business, we will move some capacity around, and also see no impact. Finally, the largest business is Fluent, which buys and sells locally. At the moment, we are still evaluating the likely impact of Brexit on local US construction markets. What is important is that we have been preparing our business to be extremely well-positioned for a slowdown scenario. We are finishing a new footprint project that will allow us to have a very competitive cost structure. Our growth line is fantastic, and we have a tremendous management team in place. It is important to mention that most of our European business is outside the UK, and is doing very well.

Now, related to our expectations for the second half. We are looking ahead to continued solid performance, with a similar margin and pricing environment as that of the first half. In the PVC, we do believe we are at the bottom of the pricing cycle, but there are no indications of a pickup over the very short term.

I also want to emphasize that VCM was always owned at market prices between PMV and Mexichem. Therefore, there is no significant impact on the price of raw material that Mexichem will buy in the future from third parties. The entire impact of the accident is contained in PMV results.

The strength of our business units combined with expectations for improved currency comparisons in the second half of the year, compared to the first half, have enabled us to reaffirm our guidance for adjusted EBITDA performance that is similar to last year's levels. Additionally, our operating cash flow should increase as capital expenditures continue to decline, and the seasonal working capital starts to decline.

Finally, I'm pleased to report that our ethylene cracker joint venture continues to be on time and on budget. We expect mechanical completion in the second half of the year, and commissioning and startup scheduled in the first quarter of 2017.

In summary, we are pleased with the operating results achieved in the second quarter and first half of this year, and are encouraged by how our organization has come together and responded to adverse conditions. Our business model is working and we are executing effectively on the strategy to grow organically and improve returns on equity and invested capital. We expect Mexichem to end 2016, a three year cycle of very high capital expenditures, with a very strong balance sheet, completing the vertical integration strategy we have been developing for several years, and focusing on delivering returns on these investments starting in 2017.

Operator, at this point I would like to open the call for questions.

## **QUESTIONS AND ANSWERS**

### **Operator**

Thank you very much, sir. Ladies and gentlemen, at this time, if you wish to ask a question, please press \* and then 1 on your touchtone phone. If you are using a speakerphone, please pick up the handset before pressing the keys. To withdraw your questions, please press \* and then 2. At this time, we will pause a moment to assemble our roster.

Our first question comes from Frank McGann of Bank of America. Please go ahead.

### **Frank McGann**

Hello, thank you. A couple of questions, if I could. One, just in terms of demand trends that you're seeing regionally, maybe you could speak a little bit about Europe, Brazil and Mexico specifically? By product, you seem to have gotten some real positive push out of data communications, and I'm wondering how you see demand developing there, and potential upsides you could have [indiscernible] there? And on the energy side, which has been a weak area, I was wondering if you were seeing any signs of any improvement at this point, and, talking to your customers, if that could be a sign of potential positive developments as you go into the second half?

Then second question, just looking broadly at your business and looking at the guidance and expectations for the rest of this year and next year, where do you see potential upsides to what you're looking for and, similarly, potential downsides?

### **Antonio Carrillo Rule**

Thank you, this is Antonio. So let me start with your first questions. On regional demand, I think it's an important question, because sometimes we don't have enough time in the present at least to talk about it. But, in general, Europe did fantastic in the first half of this year, I would say. I would almost call it our European first half. On the Vinyl side, it did an incredible job. It exceed our expectations by a lot and helped us compensate some of the PMV impact.

On the pipe side, the team also did an incredible job over there. Margins are up. Most of the businesses that we have doing poorly are now doing better, much better, I would say. In general, we saw pretty strong demand, and as we mentioned before, we also concentrate on net income, and most of our European countries have positive net income, even the ones that were doing poorly. So, I would say Europe, overall, extremely pleased with the results, with the management team, and with what's happening there.

You specifically asked for Brazil and Mexico. Brazil, it's an interesting set of data when you analyze it in detail. Last year, for whatever reason, our Brazilian business really collapsed in the second half of the year. We had a fantastic first half in 2015, and we really started feeling the impact in the second half. So for 2016, we had a very difficult comparison period. To give you an idea, we are around 20%

below in volumes in Brazil in pipe, compared to last year.

The second half, on the other hand, will have a much better comparison side because last year, if you remember, in September we did the big adjustment in our footprint there. We closed two plants, we reduced about 1,000 people in Brazil, and since December we started improving our business down there. I can tell you that the month of June was the best month we've had in a year. I am not saying everything is over, but I think our business is stable, demand has stabilized, and we are looking much better. But it's still weak demand. The demand is still weak, but our business is well positioned.

Mexico, I would say that housing continues to be very good. We are growing in the housing sector. And as you know, it's not the big housing developers. It's more through the self-construction market, where we continue to do well.

Infrastructure and irrigation projects are relatively slow. We expect a better second half. That's one of the upsides we see. Overall, in Latin America, we expect a better second half in the infrastructure side.

The datacom you said for specifics, and that's a business that... Rodrigo mentioned that our volumes are down in the US. When you compare a pipe that's targeted towards the energy business, it's a very thick and very large diameter, very heavy pipe, and the datacom pipe is a very small, very light pipe. That's why you see volumes coming down. It's not that our orders are down. I would say it's shifted demand, from a very heavy product to a very light product with much better margins.

So, that's why you see the margins going up when volume is going down. Demand is extremely strong. I can tell you we are running at capacity in the US, we are expanding capacity at the moment. We are building two plants, are investing in new equipment, and we are not doing it fast enough. So we need to accelerate the rhythm, and that's probably another one of the upsides that we have, the datacom. And it's also doing extremely well in Europe. Datacom, specifically Latin America, we have now salespeople and capacity starting to be set up in Mexico, in Peru, in Colombia and in Brazil, and it's starting to pick up, but it's going to take us a little while.

On the energy side, specifically in the US and in Mexico, but our biggest exposure is in the US. We continue to see relatively weak demand. We shut down two plants last year. We recently saw some things starting to pick up, and we are seeing at least some positive conversation from our biggest customers. So I'm not sure it's going to happen in the second year, but of course we are ready to increase capacity and to start up our plants as soon as we see signs that it's needed. Today, we have enough capacity, and we are ready to pick it up.

On the upsides and downsides, as I mentioned in my comments, this quarter the sales in our Fluor business in cement picked up significantly. I've been talking about this project of selling to cement customers for a while already, and I've told you this is one of our key strategic initiatives, and that's why you see increased volume, but reduction in prices. The price for cement fluorspar is lower than the rest of the fluorspar because it's rough fluorspar. We don't have to process it. So we take it out of the mine and immediately sell it as it is, as pure rock. Therefore, the costs are very low and the margins are high, and that's why you see higher volumes, lower prices and higher margins. It's a combination of that we're selling a product that has higher margins, but it's cheaper.

I see upside in the datacom business for sure. I think our European business will continue to do well in the second half. At the moment, we have not seen any impact of Brexit. As I mentioned in my remarks, it's about 8% of our sales in the UK, but about 5% only is in the pipe business, and today it's doing very well, but it's very targeted towards construction in the UK, so that might be [indiscernible] in the second half, or 2017 we might see some slowdown. But we have new projects going on, new

programs going on. We invested, as I said, in a new footprint. We shut down a facility, and increased the capacity in another. We shuffled our warehouses and I think we're very well prepared for a slowdown.

On the Vinyl side, I think that we had a very low pricing point in the first half of the year in North America, and I think there's some potential upside there. On the other hand, in Europe we had a very strong first half in Europe, and there could be some downside there. If you ask me, we are much bigger in North America than in Europe, so the combination is good for us. The higher the margins in North America, the better for us.

On the Fluor side also, as you know, we're going through these anti-dumping procedures in the US for Chinese gases. There were some positive developments on one of the cases this week. That is a product that we really don't sell. It's a blend. But we should expect in the second half some news about our case, and I will be more conservative this time and tell you I'm optimistic, but let's see where it ends.

I would say Latin America, of course, you will see much better currency comparisons in the second half. The second half of last year was where the currencies really moved very, very significantly. So the first half was very difficult for comparison purposes. You will see a much better situation in the second half.

That's my overall view, and I hope I answered your questions.

**Frank McGann**

That's great. Thank you very much.

**Operator**

Thank you. Our next question is from Nikolaj Lippmann of Morgan Stanley. Please go ahead.

**Nikolaj Lippmann**

Hi, good morning, and thanks for taking my questions. Congratulations in the strong operating results.

Two questions, if I may. First, I was wondering if you would be willing to discuss the risk of raw material in the long-term in Veracruz, particularly for VPM and around the ethane situation there? And, if possible, if you could discuss, is it all on the table to reconsider whether you want to rebuild the plant at all, or maybe at a different location? Also, in relationship to the supply situation, I was wondering if you could comment on how secure you feel about securing VCM for the next couple of years, from alternative suppliers? And finally, I know you commented on it in initial remarks, but when would you start operations in Texas? When will you start testing? When will you start commercial operations? Thank you very much.

**Antonio Carrillo Rule**

Nikolaj, can I ask you to repeat the first question? That I didn't get.

**Nikolaj Lippmann**

Yes, how secure do you feel about the ethane supply situation over the next couple of years, and whether there could be a debate, would you consider whether you were going to rebuild the VCM plant in PMV at all, because of some of those high risk in Veracruz?

**Antonio Carrillo Rule**

The FA situation, you're referring to the situation in Mexico?

**Nikolaj Lippmann**

The Pemex supplies situation that has been published in newspapers.

**Antonio Carrillo Rule**

I'll make a quick comment. The situation is that there's a combination of two things: A combination of supply of ethylene that has been declining over the last I would say year, but accelerating over the last few months; and at the same time, a big player in the industry increasing the consumption in Mexico. That combination has, I would say, destabilized the ethane supply in Mexico in a very significant way.

From every conversation I've had, specifically with Pemex, I think they're doing a lot of adjustments to be able to cope with these changes. I'm not the right person to comment on these things, but I think we're going through a period of a lot of changes happening to the supply. And it's a very good question, because if we're going to rebuild the plant, we need to have for sure certainty on the supply of VCM. That's something that we are going to be discussing with our partner over the next few months.

What I can tell you is that our insurance policy, as I mentioned in my remarks, it's set up for a replacement cost of a new facility in that region. But that's the amount of cash that they're going to pay us, but it doesn't have a limitation of whether we have to build it there or not. It has a limitation on the amount of money they will give us, a replacement plant in that site, but we can build it somewhere else.

What that means is that at this moment, and with the current situation that we have, and all the information we have on the table, we are analyzing all the options that we have together with our partner to see where we can invest that money in the best possible way. It is important to mention that the vertical integration strategy for Mexichem continues to be very important, and a critical part of our strategy, so we will want to continue to integrate. But I think it's wise to, with this kind of event that we have, and with the insurance policy we have, to evaluate all the options. And hopefully by the end of the third quarter, we can give you more details on the way we're thinking, but there is different avenues of how we're evaluating this.

I think that answers your first and second question, the FA—

**Nikolaj Lippmann**

Yes, thank you, Antonio. And just a follow up there, if I may. And you feel confident that you have the sufficient VCM, you'll be able to source sufficient VCM for the next couple of years in the market after the explosion. Are you confident that you have good prices and good contracts there?

**Antonio Carrillo Rule**

Yes, we are confident that we can source it. As I mentioned in my remarks, the PMV always sold to Mexichem at market prices, so we have no impact in Mexichem from buying in the market or with a good contract, and we have been able to secure those contracts, and we have received offers to increase supply in the following years. I don't see any problem in supplying VCM.

And your final question on the cracker, as I mentioned, we're going to start testing, and finish mechanical completion in the second half of the year, early in the second half of the year, and then start testing, and have commissioning and commercial startup in the first quarter of 2017.

**Nikolaj Lippmann**

Thank you very much.

**Operator**

Thank you. Our next question is from Vanessa Quiroga of Credit Suisse. Please go ahead.

**Vanessa Quiroga**

Yes, hi, Antonio, Rodrigo, Berenice, and all the team. Thank you for the call.

My first question is regarding the replacement costs of Clorados. Can you disclose that amount that you could be able to recover from insurance?

Secondly, a more strategic question about the Fluor business. How do you see that business evolving for you in the coming couple of years, in terms of sales mix and volumes and margins? Thank you.

**Antonio Carrillo Rule**

We cannot disclose the specifics of a contract. First of all, good morning. We cannot disclose the specifics of the insurance policy. What I can tell you is that, as I mentioned, it's built and was signed with a replacement cost of a new plant. And we wrote down the book value of the plant, of the old plant with some investments. So what I can tell you is that the replacement costs of a new plant is higher than what we wrote down.

On the other hand, the Fluor business. I'm very excited about what we're doing in cement. If you look at our numbers over the last four years, we've lost a significant amount of demand in fluorspar on the metallurgical side for several reason. I would say the most important is, as you know, the Chinese have exported a significant amount of steel around the world. That has impacted our customers, and they're reducing the demand for our fluorspar.

Right now, we're seeing a pickup in demand in the steel industry over the last few months, which is something that we had not seen in a while. But we've lost somewhere around 250,000 tons of sales in fluorspar, little by little, and we are recovering those sales with a very high margin product that we believe brings a lot of value to the cement industry. We have a team now dedicated to it and we are gaining a lot of traction, and I'm excited about how that's looking.

So, I would say that the focus over the next few quarters is going to be on the upstream, which is where we have the biggest margins, on increasing our sales, and being able to capture more and more of the world market in fluorspar.

On the downstream side, we are excited about a lot of the medical applications that we have. We continue to grow in our medical gases. And, as you know, we bought up some patents last year, and we are starting to build on them, and we continue to develop new products. That's an area that we believe is going to continue to grow over the next few years. Today, it's only about \$10 million in a bid that we see significant expansion of that part.

On the refrigerant gases, I would say we had a good first half. We continue to debate how we're going to progress on that side. There is still a lot of avenues open to us, and there's a lot of discussions happening on how we're going to continue to participate in that market.

What I can tell you is that, based on the strategies we're following, I would say that our refrigerant gas demand will increase in some of the areas where we have bigger businesses. We have started signing contracts in Central and South America, and we have a few contracts that we are signing also in Europe that are very important. So, even though there's a change in the market with the new refrigerant gasses of low warming potential potential, I still see that there's potential for our business to continue to capture new markets and new opportunities, and that's where we're focusing at the moment.

**Vanessa Quiroga**

Great update, Antonio. Thank you.

**Operator**

Thank you very much. The next question is from Felipe Santos of JP Morgan. Please go ahead.

**Felipe Santos**

Hi, Antonio. Good morning. Just a quick question. You mentioned before that the focus of the company right now is on the vertical integration and organic growth. Given the expansion of the energy market in Mexico, with everything that's happened since a couple of years ago, with all the changes, would it make sense for you to ally with an E&P company to have secure gas sources so you can invest in new plants and new projects, and escape any supply of ethane in the future?

**Antonio Carrillo Rule**

Thank you, Felipe. The situation that I feel is in Mexico, it's going to take a while for new players to start developing, and really making a significant change in the supply is going to take a while. I think the big evaluation has to be how is it that it is compared to bringing ethane from North America, from the US? That's I think the big discussion that's happening. How do we evaluate those two situations? I think there's opportunities to bring some ethane. But it's going to be, that's a discussion that I think where Pemex has to be involved and there's other opportunities.

At the moment, we are not participating with anyone in developing fields. That's not our core competency.

What I can tell you is that the way Mexichem is approaching growth is, as I think I mentioned in my previous comments, we have developed this new growth model where we are trying to use every one of our countries as a growth platform for all of the Mexichem products, and we are finding that there's a lot of opportunities, organic and also inorganic, but I would say mainly organic, of growing the rest of the [indiscernible] in the countries where we don't participate. Let me give you examples.

In India, for example, where we sell mainly polyethylene 5, there's a lot of opportunities for the rest of the products of Mexichem. In Brazil, I just mentioned we have a very large business selling pipe, and a very well-known business down there. But in the past, we did not sell any fluorspar. We have started selling fluorspar in Brazil through using our platform. We have signed refrigerant gas contracts, and there's significant opportunities in compounding and other products. In the US is the same thing. We have not built around the platform to grow Mexichem.

So I think the focus of the company is going to be on making sure that we increase return, equity return, invested capital. And I think this organic and small bolt-on acquisitions to grow our platforms are going to play a key, integral part in how we develop Mexichem, going forward as a growing company that develops and delivers high returns. That's where the focus is going to be.

**Felipe Santos**

That's perfect. Excellent. Thanks so much.

**Operator**

Thank you very much. Our next question is from Fernando Perez of GBM. Please go ahead.

**Fernando Perez**

Good morning. I have just one brief question regarding the PMV [indiscernible]. I was wondering if you could give us some timeframe on when do you expect the insurance company to reimburse you, and

when do you expect to have a business plan on when do you expect to replace the facility, and when do you expect the new facility to start operations? Thank you.

**Antonio Carrillo Rule**

So, based on the financial data, the government authorities have finished their investigation, and we should receive the first report in the next few weeks. But that's really for the government investigation. I would say the root cost analysis, which is an important one, and the probable cost analysis that will determine the insurance policy, during this quarter we should receive something. Probably in the early part of the quarter, this quarter we should have something.

With that in mind, we will be able to claim the insurance and then work with the insurance companies on the details of how we're going to be adjusting the value of the plans, and working with them on the business plan. Of course, we're working already on the business plan, going forward.

As I mentioned in some of Nikolaj's questions, we're working through different business plans that we are working with our partner, to try to make sure that we invest in the best possible way the funds that we should receive from the insurance company. I'm sure I didn't answer your question as specific as you would like, but, at this moment, I would like to receive the investigation first, and work with our partners during this quarter to have a better idea of how the future looks for PMV.

What I mentioned before is that it continues to be a key strategy for Mexichem, and we will work with our partner to make sure that we have the best option in how to invest those funds in the future.

**Fernando Perez**

Thank you very much.

**Operator**

Thank you. Our final question is from Pedro Medeiros of Citi. Please go ahead.

**Pedro Medeiros**

Good morning, guys. Congratulations for the results.

I actually have three quick questions. They're kind of objective, apart from the first one. Antonio, you commented at the beginning of the call that [indiscernible] PVC very close to the bottom of the cycle. Do you mind to provide some additional color on how do you see stocks across the supply chain, any potential for margin expansion in the near-term or towards the second half for PVC and compounds as a whole?

My second question is regarding the chlorine and the soda plants. I just wanted to understand if these two facilities are up and running, and whether should we expect any positive contribution from those two results in the third quarter, given what happened with the VCM facility and PMV?

And the last question is if you could also comment on the operating rates of the company's Las Cuevas mine, just to have a sense on the potential upside from accretive sales of fluorspar over time from here? Thank you so much.

**Antonio Carrillo Rule**

Let me start with the first question, PVC. We are convinced that the PVC cycle is at the bottom. You even saw some of the acquisitions that happened recently, multiple that paid for the cycle upfront, no? The reason we see this is there's no significant capacity being added in the last few years, globally, and demand continues to be strong. There's good demand for PVC. If you combined good demand with no

additional supply, and being present now producing the largest amount of our PVC in North America, that we will be tied to shale gas costs. I think we're going to be in a very good position to grab margin expansion over the next few years, I would say.

What I mentioned in my comments is at the moment I don't see it. I didn't see it in the first half. At the moment we see some improvements in pricing in PVC, but it's not significant.

One thing to consider with Mexichem, and let me try to be a little more specific about my comment, Mexichem does not export to the US. Mexichem mainly exports to regions in the world that produce PVC based out of naphtha. The US is a very small business for us. Only specialty products. We produce locally, and we export some.

So the business model producing PVC with shale gas costs, and exporting to regions that have higher costs. That's what we see happening in the future. Oil prices have recovered, now they're a little lower again, but we are positive about oil prices and the gap of producing PVC from shale gas will continue to have better margins.

What you have seen recently is that the price of PVC exports in the US, compared to local prices, has shifted around. Today, export prices of PVC are lower than domestic prices, and that's not a normal situation. Normally, it's the other way around. At some point in time in the near future that should turn around, and we should see some pickup in margins also, not only from increased demand with no additional supply, but also this strange situation of reverse pricing that happened recently.

On the chlorine and caustic soda, we are a very small player in chlorine and caustic soda. We have two plants in Mexico. One is not owned by D&B, one is owned by Mexichem. That's why we call the business unit Resins, Compounds & Derivatives, because the derivatives is a small chlorine plant we have in the west part of Mexico that takes care of the local market. That plant is doing very well, and it's operating at full capacity.

PMV is operating at around 50% capacity, and the main reason is that it's difficult to export chlorine and to move chlorine around, because it's a very dangerous material, and we have stepped out of the market, because we were supplying the chlorine to the VCM facility. We are getting some customers back from the first week after the accident, we started operating the plant. The plant is in great shape. That plant, just as a reminder, is operated with Mexican employees, it is not operated with Pemex employees. So it's a [indiscernible] Mexican plant, and it's under the Mexican standards and everything, so it's a very safe and very good plant. But it's operating at a low capacity.

We do expect some increases, but we are not going to be able to operate at full capacity in the near future, until we make some decisions with the VCM. I can tell you that with the plant as it is, we should be able to maintain PMV above breakeven point, even without running the ethylene plant.

On the operating rate of Las Cuevas, which is your third question, as I mentioned to Vanessa, we've lost volume over the last few years. It's operating at about 70% capacity, 75% capacity, and we have a significant upside on volumes, and that's what you're seeing in this quarter. You saw some volume increase. Even though pricing was low, the margins increased because of the type of product we're selling to the specific applications that we're selling. So we see potential upside in the volumes in fluorine, and margins continue to be very good.

### **Pedro Medeiros**

Thank you so much for the answers. They were very clear.

## **CONCLUSION**

### **Operator**

Thank you very much. Ladies and gentlemen, that concludes our question and answer session, and I would like to turn the conference back over to Antonio for any closing remarks.

### **Antonio Carrillo Rule**

Thank you for attending the conference. I just want to make one final remark. In my last remark in my prepared remarks, it expects to finish 2016 ending a very difficult cycle in terms of capex, three years of a lot of capex, and the focus of the company is going to be on capital allocation in a very disciplined approach for 2017, to continue improving margins and get the return on those investments that we should be getting. I think Mexichem starts 2017 in a very healthy way, with a lot of projects and a very exciting time going forward.

### **Operator**

Thank you very much. Ladies and gentlemen, that concludes this conference. Thank you for attending today's presentation, and you may now disconnect your lines.