Sensient Technologies Corporation

Q3 2019 Results Earnings Conference Call

Friday, October 18, 2019, 09:30 A.M. Eastern

CORPORATE PARTICIPANTS

Steve Rolfs – *Senior Vice President, Chief Financial Officer*

Paul Manning – *Chairman of the Board, President, Chief Executive Officer*

PRESENTATION

Operator
Good morning and welcome to the Sensient Technologies Corporation 2019 third quarter earnings conference call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key (*) followed by zero (0). After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star (*) then (1) on your touchtone phone. To withdraw your question, please press star (*) then two (2). Please note, this event is being recorded. I would now like to turn the conference over to Steve Rolfs. Please go ahead, sir.

Steve Rolfs
Good morning. I am Steve Rolfs, Senior Vice President and Chief Financial Officer of Sensient Technologies Corporation. I would like to welcome all of you to Sensient's conference call to discuss 2019 third quarter financial results. I am joined this morning by Paul Manning, Sensient's Chairman, President and Chief Executive Officer. This morning, we released our 2019 third quarter financial results. A copy of the release is now available on our website at www.sensient.com.

During our call today, we will reference certain non-GAAP financial measures, which we believe provide investors with additional information to evaluate the company's performance and improve the comparability of results between reporting periods. These non-GAAP financial measures remove the impact of currency movements, depreciation and amortization, non-cash stock-based compensation, the impact of the 2017 U.S. tax legislation and other items as noted in the company's filings.

Non-GAAP financial results should not be considered in isolation from or as a substitute for financial information calculated in accordance with GAAP. A reconciliation of non-GAAP financial measures to the most directly comparable GAAP financial measures is available on the Investor Information section of our website at sensient.com and in our press release. We encourage investors to review these reconciliations in connection with the comments we make this morning.

I would also like to remind everyone that comments made this morning, including responses to your questions, may include forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Our statements may be affected by certain factors, including risks and uncertainties, which are discussed in detail in the company's filings with the Securities and Exchange Commission. We urge you to read Sensient's filings for a description of these factors. Please bear these factors in mind when you analyze our comments today.

Now, we will hear from Paul Manning.

Paul Manning
Thank you, Steve. Good morning. This morning, we released our third quarter results and they were below my expectations. Before I provide an update on our businesses, I would like to comment on what we are seeing in the market and how that is impacting our results.

The first market dynamic I will comment on is the overall softness in a handful of product lines. The overall market in North America and Europe for food and beverages, which includes a broad array of product categories from pet food to soup, has been down for the trailing 12 months. We have been directly impacted by this slowness, particularly in our flavor ingredient product lines, which has a significant presence in soup and yogurt as well as other categories. Despite the slowdown, we are experiencing successes in a number of areas, such as ice cream, natural colors, and pharmaceuticals. In addition, our North American savory business is turning around and is well positioned for next year.

Turning to cosmetics, the cosmetic makeup market remains soft. The rebound continues but is about a quarter or two slower than originally anticipated. That said, we have seen promising signs in our order patterns and a full rebound in certain geographic locations and customer segments. We expect the cosmetic business to be back on track in 2020.

Another market dynamic has been the challenges caused by economic, political and trade uncertainty. The impact of tariffs has resulted in higher costs for certain raw materials from China and has caused other suppliers to raise their prices as well. In most situations, it has been difficult to pass on the full impact of the tariffs through pricing. Tariffs have also impacted revenue as they have created conditions in certain regions, which have led to deferred product launches, destocking and general uncertainty.

Shifting to Europe, Brexit continues to drag on impacting our customers' order patterns and overall cautiousness on purchasing decisions. Furthermore, recent discussions on U.S. imposing European tariffs have also contributed to this uncertainty. During the third quarter, our U.K. business was down substantially, and we experienced lower demand in Europe for flavor, color and cosmetics.

Another market dynamic relates to changing consumer trends and the impact on our customers. Many of the largest multinational customers are struggling to address rapidly changing consumer preferences. They are under pressure to find ways to grow. Many are focused on raw material cost reductions and are also rationalizing their product lines. We have felt the impact of the cost focus in these rationalization efforts.

For smaller and midsized companies, what we call B&C customers, there is a continued focus on introducing new products. This is good news, but these launches are smaller, and the success rates have been uneven.

Now, let me outline what we are doing to address these market conditions. First, we are focusing on key markets, food colors, finished flavors and extracts, cosmetics, pharmaceuticals and natural ingredients. Second, we are divesting certain business lines. Third, we are continuing to reduce our cost structure, and lastly, we are focusing on our free cash flow.

Going forward, we will exclusively concentrate on our key strategic markets, food colors, finished flavors and extracts, cosmetics, pharmaceuticals and natural ingredients. Within the color group, we continue to see strong demand for natural colors and pharmaceuticals. The pharmaceutical product line is up double digits for the year and natural colors are up nearly double digits for the year. We expect this strong growth to continue into 2020 and beyond for both businesses.

Our cosmetic business continued to deliver strong margins, and as the market normalizes, we should return to year-over-year growth in this business. I therefore expect growth in 2020 and beyond. Food colors, cosmetics and pharmaceuticals will constitute the core strategic focus areas for the color group going forward.

In the flavor segment, we continued to deliver solid sales growth in finished flavors and extracts, which are up mid-single digits for the year. We are also seeing positive momentum in our North American savory, sweet flavors and Latin America flavor businesses, which are all winning many new projects. Finished flavors, extracts, taste modulation technologies, and natural ingredients will constitute our core strategic focus for the flavor group going forward.

To further solidify our strategic focus, we are divesting the inks, fruit prep and fragrance business lines. We do not enjoy the scale in these markets to effectively compete in these business lines any longer. These business lines have been significant headwinds for the company for several years. We believe we can refocus and maximize our investments in our core businesses and improve our overall product portfolio and growth prospects. I anticipate that our ability to deliver consistent results will be greatly improved without the headwinds and distractions of these business lines.

In the short term, we will use the proceeds to reduce debt and thereafter we will use the proceeds to acquire businesses in our core focus areas. Another way we will overcome these market challenges is to continue to reduce our cost structure in both flavors and colors. We have made progress in reducing our production and SG&A cost in both groups. The reduction of these costs better aligns our organization to our key strategic areas and will provide an improved profit picture for both groups moving forward.

We also continue to focus on our free cash flow, starting with inventory. Coming out of restructuring, we built our inventory to improve our customer service commitments. Having reestablished excellent customer service levels, we are now focused on reducing our inventory levels, which have come down by $20 million since December. We have also reduced our capital expenditures consistent with our smaller post-restructuring production footprint.

Taken together, the reduction in inventory and capital expenditures has contributed to an increase in our free cash by $35 million, more than 50% this year. With this cash flow, we have reduced debt by $129 million over the last 12 months. We have experienced some exceptionally challenging market dynamics this year. Our actions to continue to focus the company, divest non-strategic business lines, reduce costs and focus on free cash flow will provide better results going forward.

Steve will now provide you with the additional details on the third quarter.

Steve Rolfs
Thank you, Paul. Sensient's revenue was $317.7 million in the quarter, compared to $342.7 million in last year's third quarter. Operating income was $38.8 million, compared to $50.3 million in the comparable period last year. Local currency adjusted EBITDA was down approximately 15% during the current quarter. Foreign currency translation reduced both revenue and operating income by approximately 1% in the quarter.

Diluted earnings per share were $0.75 in the quarter. During last year's third quarter, we finalized our estimate of the impact of the 2017 tax legislation. The diluted earnings per share in last year's third quarter of $1.12 includes $0.17 of tax benefit related to finalizing our estimate of the U.S. tax law change. The adjusted results for 2018 remove the impact of the tax legislation accounting and were $0.95 in last year's third quarter. Foreign currency translation reduced EPS by approximately $0.01 in the quarter compared to last year's adjusted EPS.

The company's consolidated tax rate was 5.9% in the quarter compared to an adjusted tax rate of 10.5% in last year's third quarter. This year's third quarter rate includes approximately $0.15 of benefit related to a tax planning strategy. Last year's third quarter adjusted tax rate benefited

$0.13 related to tax planning actions taken in response to the tax law changes. The company's year-to-date consolidated tax rate is 17.5% compared to last year's adjusted rate of 17.1%.

As reported, cash flow from operations for the third quarter of 2019 was $51.4 million. Capital expenditures in the third quarter of 2019 were $9.5 million compared to $10.1 million in the third quarter of 2018. Cash flow from operations for the first nine months of 2019 is $127.6 million compared to the adjusted results of $100 million for the first nine months of 2018, an increase of 28%. Our free cash flow in the first nine months of 2019 was $101.5 million compared to adjusted free cash flow of $65.9 million in the first nine months of 2018.

We continue to focus on reducing our working capital, particularly inventory and we are seeing positive results. The company's total debt decreased $40 million during the quarter and $129 million since September of 2018 to its current level of $637 million. The company now anticipates that our full year EPS will be in the range of $2.90 to $3 per share. We continue to expect our full year local currency adjusted EBITDA to be below last year's results.

Thank you for your time this morning. We will now open the call for questions.

QUESTIONS AND ANSWERS

Operator
We will now begin the question-and-answer session. To ask a question, you may press star (*) then (1) on your touchtone phone. To withdraw your question, please press star (*) then two (2). At this time, we will pause momentarily to assemble our roster.

Our first question comes from Brett Hundley with Seaport Global. Please go ahead.

Brett Hundley
Hi. Good morning guys.

Paul Manning
Good morning.

Steve Rolfs
Good morning Brett.

Brett Hundley
Paul, one of the questions that I am getting a fair amount this morning from clients is, as you guys decide to explore strategic alternatives for certain product lines, why not sit down and review the entire business as a whole?

Paul Manning
Well, I always look at the entire business and the pieces that we are selling are those that are most obviously better resting in the hands of another market participant. These are businesses that I think scale is very important, market position is very important and in some cases, these are very much legacy businesses of Sensient, and so these are quite different from the businesses that we talk about from a core focus of food colors and flavors and pharma, et cetera. So, two different worlds, and I think that based on where the company is right now, these have been the biggest headwinds to us and it makes the most sense to take these pieces to sell them again to a buyer with a much stronger position in the market where they can take advantage of their scale and their ability to cover a wide range of customers and to maintain a good position.

Brett Hundley
Thanks for that, Paul, and to follow on, what type of a market do you think exists for these business lines at a high level?

Paul Manning
For the three that we are selling, these are obviously markets where scale is very important, and as we describe our business, we are a specialty company. We are making specialty ingredients that are based on far greater degree of customization. They are not necessarily built on large capital volume driven plants, and so again, I would speak to these as being very much legacy businesses for the company. At one point, these were very different markets than they are today. So as markets mature and develop, there is a natural progression of the product line and certainly we are no different, but the remaining businesses that we focus on, it is a very different situation for Sensient, right. You saw our food colors results. You see that Sensient is an indisputable market leader in food colors and we outgrow the market in just about every one of our geographies. You look at our cosmetic business where we have a top market position. We are in a situation right now with makeup that I think certainly we cycle through that one in the short term and we are back where we were, a very strong technically driven compelling market position business.

Ditto for, as you think about the rest of the focus areas that I have discussed, SNI, our agricultural business, we are a top market participant. So, it is a lot easier to grow businesses where you have that type of leadership position, where you have that type of influence. It is much more difficult to do that in the market where you are one of many where perhaps scale is more relevant economic factor in your success.

So, I think the divestitures make a great deal of sense for us, and quite frankly, they make a great deal of sense for the buyer too. So, I think this is a very good outcome for both parties, and I think this will, as you heard me say in the prepared comments, this removes a lot of the headwinds and the distractions that we have faced in these business lines for the last several years. So, I think that is a real high positive for the company to rethink the portfolio as we have.

Brett Hundley
How easily can these business lines be separated, a two-part question. How easily can these business lines be separated? And then I had to go back to my old initiation to add everything up, but I am getting to around 20%, 25% plus of your combined revenue line that could be "under review" relative to the businesses that you mentioned. Am I in the right ballpark there?

Paul Manning
So, for the first part, I think you could almost describe them as mutually exclusive from the other parts of the business, right. They operate in different production type environments. In some cases, they have very different customers. Clearly, in the case of inks, that is the case. So, the ability to separate them is, I think, it is a pretty clean evolution. It is not easy, but it is a fairly clean separation that I think can be readily done. If you are thinking of kind of magnitude, think in terms of about 10% of the revenue, not 25%. 25% would be a very high estimate. It is more like about 10%.

Brett Hundley
Perfect. Thanks for clarifying that, and then just one more for me. At the outset here, you talked about a number of the things that have contributed to softer than anticipated results this year. A couple of them we have been aware of. They have been ongoing. For Q3, specifically, it sounds

like cosmetics just did not progress as you thought it would, and then it also sounds like some of your ingredients just have not progressed as expected. You also mentioned the U.K. as well, but is there something that really stands out in so far as the shortfall in Q3? And that is it for me. Thank you.

Paul Manning
Okay. So, what really stands out in Q3 as contributing to the shortfall, the two you mentioned, these flavor ingredients and the cosmetic market. So, let me take the cosmetic piece first. When we first observed the slowdown in demand for cosmetic makeup products, it was very much focused on makeup. It excluded skin, and it was more of a mass market type outcome. This did not really affect the high-end makeup products. Those tend to be resistant to really any economic changes in the markets. As we saw that happening, we had anticipated and go back about a year that these businesses, these geographies would sort of resume normal demand in sort of this orderly fashion beginning with the U.S. and Europe and then eventually flowing through to Latin America.

In reality, what happened here, it was reversed. We have determined that or we have seen that Latin America is very much back on track. They had a very strong outcome in Q3 and in Q4 here as we are sitting here in late October. Where the recovery has been a little bit slower than we had anticipated is in the U.S. and in Europe. Asia was really principally impacted by the U.S.-China tariff, which had a profound impact on many of the customers that we sell to in China who export to the U.S. and other markets. So, when you look at this market, you would say, we are a market leader. You would say that this downturn in our businesses is not the result of some competitive action that has taken our business. This is not the result of some technological innovation that Sensient missed the boat on. So, it is still fundamentally a very good market. It is still fundamentally a market that we are a leader in, and so what is frustrating here is the recovery has not been as fast as I had anticipated, but I think this is still a very strong market. As I mentioned, we have already seen some of them come back. I think we can expect Asia to get very, very close to resuming things here, even in Q4, but I think as you look at 2020, we would anticipate that the rest of the geographies are back in place.

With respect to the second one that I mentioned, flavor ingredients, yes, that was an enormous headwind to us, absolutely. Because you look at, our natural colors were up, our flavors sales were up mid-single digits, our pharma business was up, and where we really felt the brunt of the revenue declines were in these flavor ingredients. This is why I go back to the point of having that market position, that market share, that volume, that scale that perhaps others do, is not something that we have, and so we have to respond to that in a thoughtful way in my opinion. The best way that we do that is we pursue a sale of those product lines. So, removing that significant headwind, remember, again flavors where we have been focused, finished flavors sales is a part of the portfolio that is up, it is growing. We are winning, and I think I feel very good about that in the future, and I feel even better when that type of success is not being concealed by the headwinds that we feel routinely in this flavor ingredient space. So, I guess that is all I have to say about that.

Brett Hundley
Thank you.

Operator
The next question comes from Heidi Vesterinen with Exane BNP Paribas. Please go ahead.

Heidi Vesterinen

Hi. So, the first question is on the exits. Would you be able to tell us how the core businesses have been growing? So excluding the bits you want to exit, and so how have they been growing in the past few years? And what will the exit mean in terms of profitability, please. That is my first question.

Paul Manning
Okay. So, the business ex these flavor ingredients and inks, right. So, let us take, I mentioned natural colors is up. It was up in the quarter mid-single digits, for the year nearly double digits, and that other than Europe, actually, although the regions are doing quite well on the natural colors front. I mentioned that for flavors, we were up mid-single digits in the quarter as well as the year. Pharma has been double digits essentially for the year. Cosmetics, as a result of the market downturns I have referenced, was down about mid-single digits. So, if you do the math, you would conclude that these flavor ingredients and inks tell a very different tale, and so I do not know how that math plays out, but ultimately these were the single biggest headwind in terms of the results. Now there is another factor too that I would like to speak to, and it does not often get a lot of attention, but the level of attrition that we are observing in the market is also quite significant. Some of this is product rationalization, but some of this is just the failure rate of new product launches.

So, our new product launches, which we review, or I should say sales that not only include new products, but also sales to existing customers, continues to be quite good. We are winning new projects, but a part of the headwind that we also see, particularly in the U.S. market is a lot of product attrition. The failure rate of new products is considerably high, and so you can be winning a lot, but things are falling off the wagon, so to speak, that makes for a bit of a headwind. So, we have seen throughout 2019 a significant rise in attrition rate.

Now attrition is different from you lost it to a competitor. My definition of attrition is customer A has a product and he discontinues that product or customer A launches a product and he only launches it for six months as a limited time offering when in fact he thought it was going to be a permanent fixture in his business. So that is a dimension of the market that we are seeing right now that is much higher than what we have seen in previous years. I think some of this is a result of the uncertainty in certain markets. I think some of this is a result of again larger customers in particular, rationalizing their portfolio perhaps not unlike how we are proposing to rationalize our portfolio. So that is how I would kind of break that up.

Heidi Vesterinen
And then in terms of profitability, will it be positive if you succeed with these exits?

Paul Manning
Let's just say, we are going to take the proceeds, we are going to reallocate that capital for acquisitions, and I do not have to buy anything nearly as large as what I am divesting to make up for that profit.

Heidi Vesterinen
And the next question on the exit is, so how far are you progressed with this? Is this a new process that you are starting now? How should we think about the timing of the sale?

Paul Manning
Yes. I don't want to get into the specific puts and takes on transactions simply because they are governed by NDAs, if they were to exist or are not exist. So, I think it is probably easier for us to just say that at this point, it is about 10% of the revenue. It is not as profitable, obviously, as the

broad-based businesses whether color or flavors, and as we progress and as we eventually culminate these transactions and assigning and a closing, we would make the results of that publicly available to all folks.

Heidi Vesterinen
Thank you, and then lastly, I guess going back to the earlier question, the first question. So, are you really set on just divesting the 10% of sales? If somebody were to come with an offer for the whole business, do you just say no? Or would you be open to a discussion?

Paul Manning
Heidi, I am here to drive value, and as you look at the business, we had a tough quarter. So, I suppose most pragmatically speaking, this would be the absolute worst time to think about something like that. I think what we want to do is take care of these pieces and then as we always do around here, continue to look at the portfolio. Markets change, markets mature and then we respond accordingly. As I mentioned, we have in mind some inorganic approaches to the business that I think we could potentially discuss here in the future. So, I think that is where we are focused. I think that is what is going to turn the ship around, so to speak, but I think removing these ingredients or removing these other lines where again we are not the market leaders, I think we will give you and others a very different feel and look for what is happening in the business, and there are very positive things that are happening in these core strategic areas, but again, my easiest answer there is I am always looking to maximize shareholder value and I think as I see it right now the best way for us to do that is to divest these three, pay down debt, acquire selectively and continue to focus in these core areas that I described, food color, flavor extracts, cosmetics.

Heidi Vesterinen
Thank you.

Operator
Again, if you have a question, please press star (*) then one (1). The next question comes from Mitra Ramgopal with Sidoti. Please go ahead.

Mitra Ramgopal
Yes. Hi. Good morning. I just wanted to follow up again on the last question regarding the divestitures. Obviously, a few years ago, you did a restructuring initiative. You divested some non-core businesses. You identified three more today, and I was just wondering if it is fair to assume after this process, a couple of years or a few years out, you are pretty much set now in terms of the portfolio you have?

Paul Manning
Yes. I mean I think the pieces that I describe where we have market leading positions are areas that I think we can be quite successful, and we are quite profitable. They are very technically driven. They are defensible sticky businesses. Very different from some of the other pieces that we have had over the years.

So yes, as I sit here today, on October 18th, I think that the residual components look pretty good to me.

Mitra Ramgopal
Okay. That is fair, and on the color group, I know one of the things you highlighted in terms of softness in the quarter in terms of profitability was the higher input cost, and I was wondering if

you could add some more detail there in terms of what you are seeing and any potential ways of easing that pressure?

Paul Manning
Yes. Where we see the inflation on raw materials is principally on the synthetic food colors, inks, within the color group anyway. Those are the areas that we had the most inflation. A lot of that was driven by the tariff. We can measure the explicit impact of the tariff on those raw materials, but what you also have is a dynamic where we are the only country at war with China in the tariff, and so our competitors who are not U.S. based, are not at war with China and imposing tariffs and so therefore they are not subject to that raw material inflation. Many of them can take different pricing strategies with their products to further take advantage of that situation, and so you have kind of a double whammy. You get the raw material inflation, and you struggle to pass along the pricing, because passing of the pricing is only by U.S.-based firms, and so that has been a bit of a profit drag for us in color. I am not going to opine as to the remediation of that tariff war. All I will say is that we will work our way through it, and I think as you think about our business over time, it is one where we can ultimately either formulate out certain raw materials or we can convert folks to natural colors. We can do a lot of things to remediate this if this were to lag on and on and on, but we have established new suppliers. Unfortunately, many of those new suppliers are fairly aware of the tariff impact and they can cost their raw materials at parity with the Chinese plus tariff factor. So, the raw material inflation, it goes well beyond just things coming out of China because of the entire market responds to that dynamic as well.

Mitra Ramgopal
Okay. Thanks for that, and then finally on the guidance. Stephen, I was just wondering what I should be looking at in terms of potential tax rate for the fourth quarter in light of the shifts you have seen earlier?

Steve Rolfs
Sure. So, coming into this year, I had expected tax to be a headwind. We had some significant planning opportunities last year in connection with the new tax law. There have been some new regs that recently came out that did provide some opportunity for additional planning. We essentially were fortunate to have a significant amount of credit carryforwards, and so we will continue to look for ways to use those to reduce our future taxes, and so in the fourth quarter, again whereas we originally assumed tax would be a headwind, I would say for the year now will probably be at or a couple points below last year's full year tax rate.

Mitra Ramgopal
Okay. Thanks again for taking the questions.

Steve Rolfs
Thank you Mitra.

Operator
This concludes our question-and-answer session. I will turn the conference back to the company for any closing remarks.

CONCLUSION

Steve Rolfs
Thank you everyone for participating in the call today. That will conclude our call.

Operator
The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.