Sensient Technologies Corporation

Moderator: Lori Hauser
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OPERATOR: This is Conference # 4758329.

Operator: Good morning, everyone, and welcome to the Sensient Technologies Corporation 2018 Third Quarter Conference Call. Today's call is being recorded.

At this time for the opening remarks, I would like to turn the call over to Mr. Steve Rolfs. Please go ahead, sir.

Stephen Rolfs: Good morning. I'm 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 2018 third quarter financial results. I'm joined this morning by Paul Manning, Sensient's Chairman, President and Chief Executive Officer.

This morning, we released our 2018 third quarter financial results. A copy of the release is now available on our website at 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 restructuring costs, currency movements, 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'll hear from Paul Manning.

Paul Manning: Thanks Steve. Good morning.

Sensient reported adjusted earnings per share of $0.95 in the quarter compared to adjusted earnings per share of $0.89 in last year's third quarter. Consolidated revenue was up 2 percent in local currency. Our adjusted operating profit was down this quarter, which is largely due to factors we have been discussing all year, although the impact this quarter was greater.

We were also impacted by some unexpected softness and destocking in cosmetic colors. Important to note is that the issues affecting Flavors & Fragrances are now behind us. The color factors are also short term and do not impact our long-term outlook. Color revenue is up approximately 4 percent in local currency driven by double digit growth in Food Colors.

Operating income was up approximately 3 percent primarily due to lower profits in Cosmetics against a very strong result in last year's third quarter. The outlook for Color is still strong and the third quarter profit dip is due to a short-term correction in the cosmetics market. Year-to-date color's revenue is up 7 percent and operating profit is up 5 percent.

The Food Color businesses performed well particularly in North America. Natural color sales grew at a double-digit pace in the U.S. The strong volume growth for natural colors was largely driven by new product launches from smaller regional companies and private label producers.

Conversely, we have observed that the pace of new product launches from larger consumer product companies continues to be slow as they focus on their core brands. They are rationalizing non-core brands and there has also been a very noticeable decrease in seasonal product offerings.

Cosmetics reported lower revenue in operating profit in the quarter against very strong results in last year's third quarter. This year's third quarter performance was due to inventory destocking.

Over the last several years, many of our customers have struggled to keep up with strong consumer demand in the makeup market and many new consumer brands were launched during this time. This year the supply chain appears to have caught up to demand which led to the destocking we saw in the quarter.

In contrast to the food business, the cosmetic business is seeing stronger demand in order patterns from large multinational customers and less so from B and C customers. Some of the smaller companies that entered the market during the past few years have since left the industry and this turnover has contributed to excess supply in the market. We expect to see some continued impact from inventory destocking in the fourth quarter.

As we forecasted during the last call, Flavors & Fragrances reported lower operating income in the third quarter. The results were impacted as expected by lower volumes due to restructuring fall out at one of our plants in North America along with higher onion costs and continued pricing pressure for onion.

On the other hand those businesses that were not impacted by restructuring performed well in the quarter with the BioNutrients, European Sweet and

Beverage Flavors, Fragrances, and Latin American businesses all delivering solid revenue and profit growth.

Over the last few quarters I've been discussing the restructuring hangover at one of our North American flavor plants. As I noted in those calls, the final step in our restructuring did not go well and it led to service issues with some customers.

More recently, the operational side of the business has improved significantly and our service levels are now among the best we are seeing across the company. However, the volume decline resulting from the restructuring fall out has been more significant than we expected and this is the biggest headwind of the group's performance in the third quarter.

In addition, volumes continue to be impacted by declines in several key dairy categories and softness from some of our larger customers. Similar to the experience in color, we are seeing product rationalization and fewer seasonal offerings.

Moving forward, there is a lot of positive commercial activity for this business both with new and existing customers. For a while, some of the customers that were impacted by restructuring were not allowing us to work on new projects. We have since been able to reengage with those customers.

Our sales base has stabilized and we are having success winning projects with new customers. Our sales pipelines continue to grow and this is reflected in more sample requests, more customer visits, and more projects. These developments are extremely positive and will directly impact our future success.

The other business with a headwind this quarter Sensient Natural Ingredients felt the impact of higher crop costs and pricing pressure for onion. As we have discussed on earlier calls, the market disruption this year was caused by unusually high level of imported product from India.

Local government policies in India created a glut of inventory over the past few years and the large backlog that existed at the beginning of the year now appears to be balanced. Recently, we are seeing more stable pricing and less pricing pressure which we believe is related to the normalization of supply at this Indian product. Fortunately, the negative headwinds in our Natural Ingredients business are now behind us.

Flavors & Fragrances has turned the corner. The restructuring and onion issues are now behind us. There are lot of positive things happening within the group.

As we announced a few weeks back, we hired our new group President, Craig Mitchell. Craig has decades of strong commercial experience managing specialty chemicals businesses. There's been a definitive uptick in our sales pipelines and other commercial activities. We have recently been added as a core list supplier by another large CPG company. Our reputation as a flavor supplier continues to build.

The third quarter results did not meet my expectations. While we are seeing strong demand for natural colors and there are good pockets of growth in Flavors & Fragrances, the magnitude of the restructuring hangover was worse than I expected and we did not anticipate the impact of inventory destocking in Cosmetics.

Having said that, I remain optimistic about our opportunities throughout the company. My long-term, local currency growth expectations for each of the groups has not changed.

Over the coming years, I expect Flavors & Fragrances to deliver mid-single digit revenue growth and mid-to-high single digit profit growth with improving margins. For Color, I am looking for mid-single digit revenue growth and high-single digit profit growth. And in Asia Pacific, I expect mid-to-high single digit revenue and profit growth.

I'd also like to talk about some significant trends in the U.S. food and beverage markets. New product launches are down about 4 percent from last year and we are also seeing a similar decrease in new product launches in Europe. Much of this is due to large CPG companies narrowing their focus to core brands.

As I noted in my earlier comments, they are shrinking their product offerings and the number of seasonal products for limited time offerings and those are noticeably lower this year.

These market trends are affecting us in both Flavor and Color. We’re also seeing pressure on raw material cost including shortages for some materials that we source in Asia, impact from tariffs on products coming from China, and the potential impact of Brexit on our European businesses.

In some cases, we'll be able to get pricing to offset the cost increases. But in other cases we have more limited pricing flexibility. The current market environment is challenging, but we are having successes in both Color and Flavor. Color continues to perform well and is generating solid commercial wins in the natural color market. Flavor, now removed from restructuring, is executing more fully on our strategy.

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

Stephen Rolfs: Thank you, Paul.

In my comments this morning I will be explaining the differences between our GAAP results and our adjusted results. During this year's third quarter, we finalized our estimate of the impact of the 2017 tax legislation.

Separately, our 2017 results included restructuring and other costs. The adjusted results for 2018 remove the impact of the tax legislation accounting and the adjusted results for 2017 remove the impact of restructuring and other costs.

Sensient’s revenue was $342.7 million in the quarter compared to $353.5 million in last year's third quarter. GAAP operating income was $50.3 million compared to $52 million in the comparable period last year. The 2017 operating income results include restructuring and other costs of $6 million. And excluding these costs adjusted operating income was $58 million in last year's third quarter.

Foreign currency translation reduced both revenue and operating income by approximately 2 percent in the quarter. GAAP diluted earnings per share were $1.12 in the quarter compared to $0.73 in the comparable period last year. The diluted earnings per share in this year's third quarter include $0.17 of tax benefit related to finalizing our estimate of the U.S. tax law change.

For 2017, restructuring and other costs reduced last year's third quarter earnings per share by $0.15. When you normalize EPS results for these two items, adjusted diluted earnings per share were $0.95 in the quarter compared to $0.89 in last year's third quarter. Foreign currency translation reduced adjusted EPS by $0.02 in the quarter.

With respect to the tax benefit related to last year's tax law changes, the U.S. government has been issuing guidance throughout the year related to the calculation of the one-time toll charge and other elements of the 2017 legislation. We were able to finalize these calculations in the third quarter, as I noted earlier in my comments, and this resulted in the $0.17 benefit to our GAAP EPS.

In addition, our adjusted EPS results for this year's third quarter include tax benefits that are unrelated to finalizing last year's estimates. This benefit increased adjusted EPS by $0.13 in the quarter and relates to opportunistic actions taken in response to last year's tax law change.

We now expect the full year adjusted tax rate to be slightly below 20 percent, while the tax rate on our all in GAAP earnings will be about 500 basis points lower. As reported, cash flow from operations for the first nine months of 2018 was $8.9 million compared to $22.2 million for the first nine months of last year.

Cash receipts on sold receivables which are now reported as cash flows from investing activities under the new accounting rules, were $91.1 million year-to-date in 2018 and $86.2 million for the year-to-date period last year.

As I mentioned last quarter, we amended the agreement for our securitized receivables and going forward we won't be reporting any proceeds from sold receivables, but this item will be shown in our 2017 comparable numbers and it was also present in the first half of this year.

The sum of cash flow from operations and cash receipts on sold receivables which represents the cash generated to fund capital expenditures, dividends, acquisitions and debt repayment was $100 million in the first nine months of this year compared to $108.4 million for the same period last year.

Capital expenditures were approximately $10.1 million in the quarter and $34.1 million year-to-date. We expect capital expenditures to be approximately $55 million this year, which is in line with our previous guidance.

Debt to adjusted EBITDA is 3.0. Barring any additional opportunistic acquisition or share repurchase opportunities, I would expect that our leverage will trend down as we use cash to reduce debt. We repurchased a small amount of shares in the quarter and we will continue to take a balanced, prudent and long-term approach to deploying our capital.

As we look ahead to the fourth quarter, here are a few things to keep in mind. We expect to see a higher tax rate, higher interest expense and higher corporate expense compared to last year's fourth quarter. The higher tax rate is due to non-recurring tax benefits that occurred in the fourth quarter of 2017 and the higher corporate expense relates to a reduction in performance-based compensation in last year's fourth quarter.

The total impact of these headwinds is around $0.10 or 12 percent of last year's adjusted EPS figure. The impact of the tax rate is approximately $0.03, the higher interest expense is about $0.02, and the higher corporate costs are approximately $0.04.

We also expect the impact of last quarter's Mazza acquisition to reduce fourth quarter EPS by $0.01 as we noted on the last call. Considering the impact of these items, we expect a mid-single digit decrease in percentage terms from last year's fourth quarter adjusted EPS results.

Thank you very much for your time this morning. And we'll now open the call for any questions.

Operator: This morning's question and answer session will be conducted electronically. If you would like to ask a question, please signal us by pressing star one. We will take as many questions as times permits. Once again, if you would like to ask a question please signal us by pressing star one.

And the first question comes from the line of Fintan Ryan from Berenberg. Your line is now open.

Fintan Ryan: Hello Paul. Hello Steve.

Paul Manning: Hello.

Stephen Rolfs: (Inaudible).

Fintan Ryan: Just two questions for me, please. Firstly, you mentioned that the performance in Q3 came below expectations at (EBIT) level. I'm wondering could you quantify what you had initially expected and what were the sort of the surprises and the moving – sort of the quantum of those moving parts? And then will – what of those sort of Q3 surprises should we expect to flow through into Q4?

And I know you've said that you appear confident, that you stabilized the situation overall in the Flavors & Fragrances business. But what does that mean in terms of stabilization into Q4 into 2019? Does this mean that you would expect EBIT to be flat or would you be more confident of getting towards that mid- to high-single digit long-term target that you mentioned?

Paul Manning: OK. So the first one, to the question about the Q3 being below our expectations, could we quantify that, what surprised us. So what I think surprised us the most or surprised me the most was the impact. I think the SNI piece, so the onion cost, was about where we expected, plus or minus. I think the impact of the restructuring hangover was the larger factor than I had expected.

I think, fundamentally, I underestimated our comparable to last year. Last year, we were able to clear out a tremendous amount of backlog in the third quarter, the amount of which could have constituted weeks, if not a month of backlog. And so I didn't fully quantify that impact into Q3. So I'd say that's probably the larger or the largest surprise that I felt in Q3. There was certainly EPS impact of several cents on that one.

I think the other one that I did not anticipate fully was the Cosmetics destocking. This was – and let me be clear on what we're talking about here. So it's not the entire personal care market, entire personal care market was up, but there's different pockets within that market that I'm on speaking to.

So where we saw this impact was principally in the makeup sector of the market. Hair care was fine. Skin care was fine. A lot of these other areas we deal and we're fine, but the makeup is where we saw the tremendous drop-off in stock requirements of our customers.

There's not been an overall decline in the end consumer market. And so this is why I describe that as essentially a temporary thing which would begin to start flowing through in Q4. So, the – those are probably the two biggest surprises for Q3.

I think the positive here that you take away from that is, as I said in the comments, we've lapped the SNI piece. We're now in a phase where we have a new crop. The yields are looking quite better than last year. Now, we'll continue to be measuring the yield through Q4 and even in the early Q1, but signs are pretty good right now.

The other situation with SNI regarding the supply of onion, foreign onion that is also normalized back to where effectively that's been for the last 10 to 15 years, so I feel very confident that we've lapped those factors. And similarly on the Flavors, this was a – this is where I had been forecasting that we would round the corner, the business would be stabilized in North America and certainly we're now seeing that impact.

So, this is kind of bleeding into your second question of what flows into Q4. I think the issue that will continue, is it continues to be a market where there's definitely some raw material pressure. I think largely we've been able to mitigate that, particularly in fragrances throughout the year, but we are seeing some uptick in raw material pricing.

The question has come out before how are our customers pushing us on pricing and certainly, there's a lot of companies you have all heard of that are really much pushing for raw material relief i.e. pricing from us. So, that will continue to be a pressure point. But I think we can largely manage the majority of that.

So, in short, Q4 represents really a turning point for the businesses. I think that these were items that we effectively had to lap and we did so in Q3. So this is why I feel like we can get to our declared mid-single-digit high-single-digit trajectory. We start transitioning to that in Q4, and certainly for – as we talk about the future of this business those expectations have not changed.

Fintan Ryan: OK, thank you.

Paul Manning: OK, thanks Fintan.

Operator: We have our next question from the line of Christopher Perrella from Bloomberg. Your line is now open.

Christopher Perrella: Good morning.

Paul Manning: Hello? Christopher?

Christopher Perrella: Hello guys.

Paul Manning: Hey Christopher.

Christopher Perrella: Yes, yes – hi. Sorry about that.

Paul Manning: Yes, no worries.

Christopher Perrella: I apologize. On your gross margin, looking at the dip and realizing the onion costs and then some of the raw material cost pressure. Do you expect sequential gross margin improvement in the fourth quarter now that you've lapped most of those issues? Is that going to turn the corner?

Paul Manning: Yes. We would expect sequential improvement in gross margin and EBIT margin. Color largely held up, continued to be better than 20 percent. And I think Asia-Pacific got near to the very high teens on EBIT margin. But obviously, Flavor dipped in Q3. But, yes, I would anticipate there would be sequential improvement across the corporation.

Christopher Perrella: Great. And I don't remember if I missed this in the prepared comments, have you quantified sort of the expected foreign exchange exposure and headwind in the fourth quarter, I guess at current rates?

Stephen Rolfs: So it should be similar. So we were between 1 percent and 2 percent in Q3, and I would expect something similar in Q4 as well, probably 2 percent in Q4.

Christopher Perrella: A similar drag on the top and bottom line or a little bit different top line 2 percent and bottom line a little less?

Stephen Rolfs: Yes, I think that's correct.

Christopher Perrella: All right. Thank you very much.

Paul Manning: OK, thanks.

Operator: Once again, if you would like to ask a question please signal us by pressing star one.

Our next question comes from the line Curt Siegmeyer from KeyBanc Capital. Your line is now open.

Stephen Rolfs: Good morning Curt.

Curt Siegmeyer: Hey, good morning guys.

Paul Manning: Hey Curt.

Curt Siegmeyer: Hey, on the Flavors & Fragrances, last quarter seems like hopefully it was the trough in terms of profitability, saw a little bit of improvement even despite it coming in a little bit worse than I think most expected here in this quarter. So how should we think about the margin improvement trajectory kind of going forward?

Is this going to be kind of a slow gradual claw back to sort of where you were and then hopefully where you aspire to get to, kind of towards that 20 percent? Or will some of these things that you talked about the improvement in service levels and whatnot that you mentioned maybe help you recover some of these volumes in sort of a step up fashion at some point?

Paul Manning: Well, so to the first comment you made, yes I would say this is a real trough for Flavors. There is no escaping the fact that Q3 came nowhere near my expectations. I'm very disappointed and, quite frankly, I'm embarrassed by what happened in Q3 in Flavors.

And so, as you look at where we need to continue to take the business and to maintain and get to this level of revenue growth and profit growth that I've been talking about, step 1, don't have the headwinds. So I think that – check on that one.

And then step 2, it's continuing to drive the top line focusing a lot on service levels, focusing a lot on sales execution, going after bigger projects, bigger wins. You saw some evidence of our success in doing that in terms of being recognized by, at least in the last year, a couple of CPG companies in terms of earning our way onto a core list.

I think that is a helpful piece. But I think a lot of the growth is going to continue to come in these B&C sectors. Again given our size, we don't tend to have a great deal of overlap with very large flavor companies. Our B&C customers could very well be their C, D and E customers.

So I think it's a good opportunity for us. I think as we generate the revenue and as the volumes improve, yes, we should definitively see a drop to the bottom line. We have the right level of investment from a production standpoint. So I think our production costs can be largely flat.

Similarly, on SG&A, we've made the investments in the technical side. Certainly, we will continue there. But I would not anticipate some massive increase in SG&A to reflect the need to upgrade substantially.

So I think the infrastructure is there for us to be successful and so therefore, with revenue, I think there is a very efficient flow through to the bottom line that we would anticipate. So the margin progression, I think this is absolutely going to – it's got to come from revenue. It's not going to come from costs, it's going to come from revenue and I think this has been a principal focus for Flavors.

The new President that I mentioned in the monologue, Craig Mitchell, this is his focus area. This is his area of specialization, technical selling, sales execution in general. So these are our focus areas. Very important to that is ensuring that, as we like to say, the trains are running on time, products getting out on time, documentations getting out on time and this infrastructure is positioned to help us win.

So these are a lot of the factors that we focus on. But we've got to come back from Q3. Q3 was unacceptable by everybody in this room and certainly by everybody on this call.

So we anticipate a much improved situation in Q4 versus Q3 certainly. And then, again, as we endeavor to reach our long-term targets, I feel like these are very achievable for us in 2019 and 2020 and beyond. And again, similar to color, I think – or similar to Flavors, we can do this in Colors as well.

Curt Siegmeyer: OK, appreciate the color on that. And if I could, just a follow-up on the Colors Group? The cosmetic slowdown as you mentioned wasn’t really foreseen as well. And you talked about that bleeding into the fourth quarter a little bit, but it sounds like the pace of growth in natural colors has kind of helped steady similar to what you had probably been seeing earlier in the year.

So I guess the question is this, if Cosmetics kind of works through that inventory in 4Q, is there any reason the Color Group shouldn’t return to kind of maybe mid- or high-single digit growth as early as 1Q or do you see any other clouds on the horizon that could prevent that from happening?

Paul Manning: No. I think what you just said accurately captures the situation. I think the cosmetics thing it is not a systemic problem. There's not been a change in market demand, there's not been some competitor that's come in and taken our business, there's not been a slowdown in terms of the need for innovation in that market.

So the core fundamentals are quite good. So this is again, this is just levelizing or level loading the supply chain between us and the producers because to the producers, to the end consumers, the demand continues to be quite good.

On the natural color front, we continue to have outstanding results there. This is an area we've talked about for years. We made lots of investments here. I think we are very well-positioned. We had across the Color Group, the whole group was up double-digits on natural colors and you may find this interesting too, we are actually up almost double-digits on synthetic colors too.

So the group, Color Group, Food Colors is executing quite well. We see tremendous growth in a lot of our areas. A lot of this is being driven by not simple building blocks that most folks can just go and buy and trade and sell. That's not where we're getting the wins, the wins are coming on say the top of a pyramid of products.

So these are the more sophisticated products with a lot of very proprietary production techniques and applications that that we've developed in-house, that has been the single biggest driver in our success in natural colors. So we think that we've got really good momentum in that business and I think that's going to continue in 2019 to the ratios you just described.

Curt Siegmeyer: OK, very helpful. Thanks Paul.

Paul Manning: OK, thanks Curt.

Operator: As there are no further questions at this time, we will turn the conference call back to the company for closing remarks.

Stephen Rolfs: OK. Thank you again everyone for your time this morning. That will conclude our call. If anybody has any follow-up questions by all means, call the company after the conference. Thank you.

Operator: Thank you all for joining us today. This concludes today's conference call. You may now disconnect. Have a great day.

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