SENSIENT TECHNOLOGIES CORPORATION

Moderator: John Collopy
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11:00 a.m. ET

Operator: Good morning, everyone. Welcome to the Sensient Technologies Corporation 2016 second-quarter conference call. Today's call is being recorded. At this time for opening remarks, I would like to turn the call over to Mr. Steve Rolfs. Please go ahead, sir.

Steve Rolfs: Good morning. I am Stephen 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 2016 second-quarter financial results. I am joined this morning by Paul Manning, Sensient's Chairman, President, and Chief Executive Officer.

Yesterday, we released our 2016 second-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 and other costs as noted in the Company's filings.

Non-GAAP financial results should not be considered an 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 (technical difficulty) forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Our statement (technical difficulty) 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: Thanks, Steve. Good morning. Sensient reported adjusted earnings per share of $0.84 in the quarter, compared to $0.80 in last year's second quarter. Foreign currency translation reduced adjusted EPS by about $0.02. And in local currency, adjusted earnings per share increased 6.2 percent.

Revenue increased 6.1 percent in local currency, driven by solid revenue growth across all of the groups. Excluding the impact of currency, both color and Asia reported double-digit revenue growth, and flavors and fragrances revenue was up approximately 3.5 percent.

Adjusted operating income increased by 5 percent in local currency, as solid growth at each of the groups was offset by the normalization of corporate costs. Foreign currency translation reduced both revenue and adjusted operating income by approximately 2 percent in the quarter.

Cash flow remained very strong, increasing 18 percent in the second quarter and by more than 30 percent to over $100 million in the first half of this year. Free cash flow was also significantly higher in both the quarter and year-to-date periods. We expect a continuation of the year-over-year growth for cash flow in the second half of the year.

Color had an outstanding quarter, led by strong performances from the cosmetic and food color businesses. In local currency, both revenue and operating income increased by approximately 11 percent and the group's operating margin improved to 21.3 percent.

Cosmetics reported double-digit growth in local currency for both revenue and operating income, driven by new product wins from our technical innovation pipelines.

The food color business also performed very well, benefiting from a continuing transition from synthetic to natural colors. We continue to see strong interest in natural colors for food and beverage applications in many regions around the world. Over the last year, many of the leading consumer products and food service companies made public commitments to use natural colors and other natural ingredients in their US-based products.

We are also seeing more new product introductions that feature natural colors coming from local and regional manufacturers as well as from private-label brands. In fact, approximately 75 percent of all new product launches now use natural colors. Our natural color sales have been strong, with double-digit sales growth in the Americas in both the quarter and the first half of this year. In the US, a little more than one-third of all products on the shelf currently use natural colors, so there is still a lot of room for growth in this market. We are the market leader for food and beverage colors, and we are well-positioned to lead the conversions to natural colors over the next several years.

Color group is now well on track to achieve our stated goal of high-single-digit profit growth in local currency and year-over-year margin improvement in 2016. The group exceeded that expectation in the first half, delivering 10.4 percent local currency profit growth, and I expect color to achieve at least high-single-digit operating profit growth for the year.

I mentioned the strong performances from cosmetics and food colors, and we expect both businesses to build on their strong first-half performances. Specialty inks has shown strong improvement in revenue and operating profit in both the quarter and year-to-date periods, aided by new wins, growth of the Xennia business and the resolution of the quality issues we had last year. The inks business has made significant progress, and it is on track to deliver continued improvement in the second half of the year.

In flavors, we are progressing with our efforts to shift the group's product mix from simple ingredients to more complex flavors, flavor systems and fragrances. We are also progressing with our restructuring program and other efforts to lower cost. Combination of upgrading our product mix and reducing our cost structure will enable us to deliver sustainable profit growth and additional margin improvement.

Flavors and fragrances had a good quarter, delivering solid revenue and profit growth. In local currency, revenue increased by approximately 3.5 percent, and operating income increased 10 percent as a majority of the group's businesses reported double-digit profit growth and margin expansion in the quarter. The group's second-quarter results include a sale of import rights in North America. Excluding this sale, flavors and fragrances delivered a solid result with local currency operating income growth of 3 percent.

The group's operating margin was 16.9 percent in the second quarter and would have been 15.8 percent excluding the sale of the import rights. It is also worth mentioning that the lack of garlic supply reduced the group's operating profit growth by about 4 percent and lowered the group's operating margin by approximately 40 basis points in the quarter. As we have previously communicated, we expect the garlic supply issue to be resolved this quarter, which will help the Group's result in the second half of the year.

Our businesses in the flavors and fragrance group are showing encouraging signs of improvement. In particular, those businesses that haven't been impacted by restructuring have been able to focus on executing their strategy, and they are making significant progress in growing operating profit and improving their margins.

For example, fragrances has been improving its sales mix, selling more value-added fragrance compounds instead of commodity aroma chemicals. The improved sales mix in this business led to double-digit profit growth and higher margins in the quarter.

Similarly, the North American savory business had a strong quarter, also reporting double-digit profit growth and significant margin improvement.

The beverage businesses had solid results in both North America and Europe.

The businesses that are impacted by restructuring have had an additional challenge of managing production consolidation activities at the same time that they have been implementing new strategic initiatives. This has not been a simple process, and these businesses should continue to improve with lower cost and better execution against their respective strategies once we move past restructuring. We are confident that the progress we are seeing at other businesses in the group will be replicated once the restructuring is completed.

We are pleased with the flavor and fragrance group's second-quarter results. There are a lot of good signs in the group, and their second-quarter performance was in line with expectations. We are maintaining our guidance for high-single-digit profit growth excluding currency, and we expect approximately 100 basis points of margin improvement for the year.

Asia-Pacific also delivered solid results in the quarter, reporting revenue and profit growth of 10 percent and 4 percent respectively excluding the impact of currency. As I noted in the last call, we are increasing our presence in this region, adding more technical and production capabilities to serve these dynamic markets.

We opened our R&D center in Singapore earlier this year, and we continued to add technical staff throughout the second quarter. This facility gives us state-of-the-art capabilities that will allow us to work more closely with our customers and to sell more sophisticated products in the region.

We are also increasing our production capabilities in Asia-Pacific. These initiatives have reduced both production and logistical costs, and they will shorten lead times for key products sold throughout the region. We see a lot of positive indications in our Asia-Pacific businesses, evidenced by the nearly double-digit profit growth in the first half the year. I expect Asia-Pacific to achieve high-single-digit profit growth and potentially double-digit growth in local currency for the year.

Corporate costs were up from last year's second quarter primarily because performance-based compensation costs have returned to a more normal level. As I noted during the last call, we have made several changes to increase the connection between pay and performance over the last few years. We have changed the mix of our long-term equity incentive awards so that 100 percent of those awards consist of performance stock units. We believe this change combined with our robust stock ownership and holder retirement requirements closely align our executive compensation with shareholder returns and expectations.

On a local currency basis, our adjusted EPS results for the first half have been consistent with our expectations at the beginning of the year, but we are on track to meet our targets for the full year. While there has been some recent volatility in exchange rates, currency has had less of an impact than we originally expected. Based on the current exchange rates, we are raising the lower end of our guidance for adjusted EPS, and our range is now between $3.20 and $3.25. Our previous guidance was $3.15 to $3.25 per share.

I am very pleased with the second-quarter results, and I'm very optimistic about the Company's future. Steve will now provide you with additional details on the quarter.

Steve Rolfs: Thank you, Paul. Sensient reported revenue of $360.8 million and $346 million in the second quarters of 2016 and 2015, respectively. Operating income was $43.7 million in the quarter, compared to $45.1 million in the comparable period last year. The operating income results include restructuring and other costs of $13.6 million in this year's second quarter and $10.5 million in last year's second quarter. Excluding the restructuring and other costs, adjusted operating income was $57.2 million in the quarter and $55.5 million in last year's second quarter. Foreign currency translation reduced both revenue and adjusted operating income by approximately 2 percent in the quarter.

Second-quarter diluted earnings per share from continuing operations were $0.55, compared to $.64 in last year's second quarter. Restructuring and other costs reduced earnings per share by $0.29 in the quarter and $0.17 in the comparable period last year. Adjusted earnings per share from continuing operations were $0.84 in the quarter and $0.80 in the second quarter of 2015. Foreign currency translation reduced adjusted EPS by about 1.5 percent in the quarter, and in local currency, adjusted earnings per share grew 6.2 percent.

For the first six months of this year, Sensient reported revenue of $703.3 million, up 4.2 percent in local currency, compared to $692.2 million reported in the first half of last year. Operating income was $91.2 million in the first half of 2016, compared to $91.5 million in the first six months of 2015.

The operating income results include restructuring and other costs of $16.9 million in the first half of this year and $17.6 million in the comparable period last year. Excluding the restructuring and other costs, adjusted operating income was $108.1 million in the first six months of this year and $109.1 million in the first half of last year.

Foreign currency translation reduced both revenue and adjusted operating income by approximately 3 percent in the first half of the year. Diluted earnings per share from continuing operations was $1.25 for the first six months of this year, compared to $1.28 for the first half of last year. Restructuring and other costs reduced diluted earnings per share by $0.34 in this year's first half and $0.28 in the comparable period last year.

Adjusted earnings per share from continuing operations was $1.59 in this year's first half, compared to $1.56 for the first six months of 2015. Foreign currency translation reduced adjusted earnings per share by approximately 3 percent. And in local currency, adjusted earnings per share increased by 4 percent year to date.

As Paul mentioned earlier, we had very strong cash flow in the first half of the year. Cash flow from operations was $54.7 million in the quarter, up 18 percent from last year's result. Year to date, cash flow from operations was over $100 million, compared to $76.9 million in the first six months of last year. We are focused on reducing our working capital balances, and these efforts contributed to the improved cash flow this quarter.

Capital expenditures were $20.2 million in the quarter, and our forecast for 2016 remains between $75 million and $85 million. Our balance sheet is strong, and debt to adjusted EBITDA was 2.4 at the end of June. We plan to keep debt levels in line with an investment-grade profile to maintain the flexibility for capital expenditures, dividend payments, share buybacks and acquisitions. We will continue to take a balanced, prudent and long-term approach to our capital allocation strategy, which includes evaluating share repurchases on an opportunistic basis.

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

Operator: Today's question and answer session will be conducted electronically. If you would like to ask a question, please signal us by pressing start one. We will take as many questions as time permits. Once again, if you would like to ask a question, please signal us by pressing star one. Your first question comes from Mike Sison with KeyBanc.

Mike Sison: Hey, guys. Really nice quarter again. Yes, can you hear me?

Paul Manning: Yes, I can hear you fine.

Mike Sison: Yes, sorry. Yes, really nice quarter again. Hey, the colors business continues to do very well. Maybe in cosmetics, could you flush out what areas are hot in that market? Where are you winning new business? Are there certain types of cosmetics that your products are really gaining some traction in?

Paul Manning: Sure. I will take that one, Mike. We've got a pretty broad-based cosmetic portfolio, as you know. We are dealing with everything from pigments that you would see in mascara to nail varnishes to hair dyes on the color end of things. But also from an ingredient standpoint, we are also fairly broad in terms of surface-treated pigments and solubilizers and things of this nature. So a pretty broad-based portfolio that, depending on which region you are in, there could be higher outcomes than in others.

In general, though, cosmetics or personal care, however you would like to define it, it's an innovation-driven industry. The products are never good enough for the end-consumer. You always want the shine to last longer, the mascara to stay on better, the hair dye to remain in your hair longer. Well, maybe not in your hair, but you get the point.

The idea here is that it's -- consumers are always demanding more performance. And on top of that, they are demanding that the products contain very sustainable -- from an environmental standpoint, from a production standpoint, and products that are more natural in their orientation. So, what those two factors in this industry compel any successful business to have is a very long-term and very broad-based innovation program. And I think that is what has been the single biggest factor, in my opinion, as to the very good growth we are seeing today. A very well-established, disciplined approach based on these various product categories, and you are seeing the execution.

So for instance, in our North America business, they had -- they shared with me earlier that they had received the largest PO in the history of their business. And it was based on a product that we had developed five years ago that the customer had been working on for, say, three to four years. So it can be a very, very long lead time item. And I think that's a dynamic that creates a very interesting outcome in the market, because if you assume they are working on these products for three or four years, they have a very good sense of what the trends will be in three to four years.

So that is some background. Now just a little bit more specifics on your question about what products specifically. I would tell you that the growth and the success is very broad-based. Makeup and hair care obviously are the big, big two. Skin treatment is also a big one, whether it's active ingredients or products that are working in conjunction with active ingredients for anti-aging or whitening effects. Again, some of that is regionally dependent. I would tell you in short that the success is very, very broad-based, and it is driven principally by the innovation efforts that we've had ongoing.

Mike Sison: Great. And then if you think about your portfolios, is this an area where maybe you could do more acquisitions to continue to -- given your footprint with customers is pretty strong, is this an area of potential expansion?

Paul Manning: Certainly could be. This is a business that we essentially acquired -- gosh, that goes back more than 15 years where we bought fairly small private businesses, invested a lot of capital, invested a lot of talent and innovation. And this is -- those acquisitions that were made 15 years ago are really the basis for this program today. So to that end, if there are additional acquisitions in a particular product line or to assist from the supply chain standpoint, those would always be very -- of strong interest to us.

Mike Sison: OK, great. And then if you think about the first half for colors, you noted that it kind of outperformed your expectations. When you think about the area that caused it to be better, what do you think those one or two things are? And are those the areas to watch for in the second half potentially to do better than your outlook again?

Paul Manning: Well, I think the first area would be cosmetics. I think we're going to continue to see that very strong success. We are off to a very strong start to Q3, and I would anticipate a very good second half for cosmetics. And then again into 2017 and beyond, because a lot of this effort has been many, many years in the making. The pipeline goes out quite a number of years. Food colors will also continue to contribute very strongly, led by the tremendous success we are having in natural colors. Once again, another business built on long-term capital investment and innovation programs which have been very successful.

A lot of the new wins we have now -- and, in fact, one of the products that we launched at the recent IFT was from a development effort that really began about four years ago.

So, those are two very good businesses for us. You build that reputation. You build that capability over time. And I think we're going to continue to see that success into the second half of this year and then to next year beyond that as well.

I think inks, as you heard me reference in the prepared comments, has had a very nice rebound in many of our product areas. We are benefiting substantially from that acquisition we made last year, doing quite well there. We have recovered from much of our challenges that we had last year in most of our regions. Obviously you have to continue to build that business back and we're doing that. But I see very good macro trends in that market, most notably the conversion from analog to digital inks, so I think we will continue to benefit from that in the second half and, then again, well beyond.

So those businesses are positioned not only for second-half improvement, but long-term -- many years of success. These are not conversions, whether you're talking about natural conversions or cosmetics or digital inks. These are not conversions that happen over a six-month period. These are conversions that happen over years. So I think it really establishes a very nice runway for us to grow and to invest in these businesses on a much long-term -- on a very long-term basis.

Mike Sison: Great. Thanks, guys.

Operator: Your next question comes from the line of Brett Hundley with BB&T Capital Markets.

Brett Hundley: Congratulations on a nice quarter here.

Paul Manning: Yes, thanks, Mike. Morning.

Brett Hundley: I guess Paul, I just wanted to start with your guidance real quick. If I am hearing you correctly, you are bringing up the bottom end of that range solely on currency. Is that correct?

Paul Manning: Well, why don't you give me the full question. I will answer all the pieces of it together.

Brett Hundley: OK. So essentially, the quarter was stronger than we were expecting on the street here. I guess I'm kind of curious how it came in relative to internal expectations. And I guess what I'm trying to parse out here is you guys effectively raised guidance yesterday by raising the bottom end of your range. And what I'm trying to get it is whether or not that is really driven by fundamentals coming in better than expected or if it is largely driven by maybe currency easing somewhat relative to expectations. So if you can kind of parse that out for me, I would appreciate it, Paul.

And then maybe just related, as there is seemingly an updated view on currency related to guidance, do you feel like you are building in any conservatism on the currency side? In other words, with where currency is today and what you've done to your guidance range, do you feel like there could potentially be some upside related to currency?

Paul Manning: OK, yes. Let me take the three pieces. As we -- as I reflect on the guidance that we gave -- I think you hit a point very, very well there. How we sequence the results and how perhaps you or others may sequence the results could be a bit differently. To put that in very plain terms, our $0.84 this quarter was about where I expected to be internally based on how we set our budgets. So that would be one comment.

As you look at the remaining-year guidance, maybe you are a little bit under-optimistic on Q3, and you are probably a bit over-optimistic on Q4. I think for the year, I think we are about in line with that. But I think ultimately how we sequence this is probably a little bit different -- in our budget is a little bit different than how it's been sequenced from the standpoint of earnings consensus on a quarter-by-quarter basis. And I don't want to get too bogged down in that. We really do focus on the year. And so as I look at the year, our range still works.

I think to get to your second point of -- OK, sequence is number one. But number two is your question about performance. Clearly, we did very well in Q2, which gives me confidence to raise the bottom end of our range. I feel good about that. Could there be upside? Hey, listen, I'm always very optimistic, but I think that I feel very good about the $3.20 to $3.25 range.

Now, the third element there you raised is on FX. In our first call of the year, I believe we quoted about approximately a $0.15 impact on FX. At the time, I felt the hay was in the barn on that one and it wasn't going to change a whole lot. But obviously, things have improved despite some of the things you are seeing with the pound to the dollar. Some of the other currencies have gone in our favor from the standpoint of dollar-denominated transactions. And so we are probably not -- we're certainly not $0.15 anymore. We are probably more like about $0.10 plus or minus for the year. So if you do the math on the quarter-by-quarter impact of that, there is clearly some benefit that we would see in Q2.

So, I think that FX -- I don't want to make any really further predictions; I'm kind of responding to what has happened. I don't think anybody is particularly good at forecasting any 90-day period on the FX. So I feel pretty good about giving you that range. Obviously, if things do go our way as a US-based Company in the coming quarters, we would update accordingly. And that could be the basis for raising guidance. But I think that the $3.20 to $3.25 for each of those reasons -- sequencing and performance and FX -- feels pretty good to me right now.

Brett Hundley: That's really helpful. I appreciate it. And maybe a second question kind of related to parsing things out for us on the analyst side. Again, my expectation was probably different than yours. The margin that you guys reported in flavors was very solid. I probably didn't expect that type of improvement until maybe later on in the year here.

And so I am trying to understand if your improvement in flavors, fragrance margins is more surrounding margin dynamics within fundamental ingredients, flavors, fragrances and a rebound there. Or if you think it's more of this restructuring continuing to come through and then add benefits for you guys. Hopefully that question makes sense.

Paul Manning: Yes, well, my answer would be yes. So it's -- there's elements of mix. There's elements of restructuring. And I think that we are on track to what I would -- had laid out in the first call of the year: approximately 100-basis-point improvement there on that basis.

In 2017, I expect -- and I will even forecast for you right now what I will tell you in February of 2017 is I'm going to tell you it's going to be between 100 and 200 next year on the operating margin improvement.

So, that is where these elements of restructuring and mix will only accelerate, I think, in our favor. There may be some culling as well that could aid in that effort, and that could also be quite important. We haven't had as much culling at this point for the year as I had potentially predicted in the beginning of the year. But as I had also cautioned folks, that is not necessarily one that is easy to predict. Oftentimes, you cull by a pricing action. And when the customer doesn't take action on your pricing action, you did not cull, but you did certainly improve your margin there perhaps on -- perhaps in an unpredictable way.

So, you could see -- because there is still more culling to be done, so you may see some more of that in the second half and certainly in 2017 as well. Does that kind of get at where you're going there?

Brett Hundley: It does; that's helpful. And just to be clear, an expectation of 100 to 200 basis points of margin improvement, is that for the segment or is that at the consolidated level?

Paul Manning: That would be for flavors.

Brett Hundley: That segment, yes. And then I just -- I wanted to revisit the corporate. I appreciate you highlighting that for us because it did jump, and I completely understand why it did. It somewhat, at the consolidated margin level, negated what you've been able to do both within colors and flavors, fragrances with segment margin improvement there.

And so I've gotten some questions on it early this morning just related to maybe how corporate might grow as you do make some of these improvements and advancements, particularly in your flavors, fragrances area on the margin side. Can you give us just some added color on how corporate might plod along as we move into years ahead and hopefully we see some of these improvements at the segment margin level? Will we indeed be able to see that consolidated margin improve over time?

Paul Manning: Well, let me take the first part, and then I want to let Steve give you some of the details on that. We have obviously, through restructuring over the last couple of years, taken a fair amount of cost out of corporate. We've also revised -- as you know and as I have advertised very strongly, we've made a lot of revisions to our compensation practices. And so each of those elements has had a fairly strong impact on not only the aggregate cost at corporate, but even how they may play out in any one given year.

You clearly saw that dynamic in 2015. That dynamic was only the result of the revisions that we had made to our compensation programs and to our long-term compensation programs as well. Those are here to stay. So I think that's a real positive for shareholders, and they should feel very confident that we only get paid when we perform. And if we don't perform, we don't get paid. And that sounds like a pretty straightforward arrangement to me.

Now, on some of the other specifics of the cost breakdown and the timing, I will pass that to Steve. But I just wanted to kind of lay out ideologically where some of that is coming from.

Steve Rolfs: Sure, Paul. Thanks. And just to give you the details, Brett, on corporate in the quarter because there is some noise there and some volatility tied to that performance-based comp, our equity incentive expense is up about $2.5 million in the quarter. And so if you just look at the ongoing corporate expense this quarter, it's a $12.2 million without the restructuring and other. That is up about $3.5 million. And, again, a big part of that is the performance-based equity.

There is a lot of positives about that program, but one of the negatives is it does introduce more volatility. So when you do true things up, change your estimates, the expense moves around a little bit. So I think it's a little high this quarter relative to where we would expect it to be the next two quarters. I would think corporate expense would be more in the neighborhood of $9 million to $10 million in Q3 and Q4, coming in at maybe $40 million to $41 million for the year. And, again, that's without any of the restructuring and other expenses. So hopefully –

Brett Hundley: No, that's really helpful. It sounds like indeed some of it is just related to timing, which we see a lot so it makes sense.

Just last one for me, Steve or Paul, I just noticed the new language in the restructuring-other talking about an impairment charge on, I think, a production facility or certain business area. And I just wanted to get more color on that if I can and maybe parse out what the size of that relative impairment charge is within the overall restructuring and other charges.

Paul Manning: Sure, Brett. In the restructuring and other, a lot of what is in there is the ongoing restructuring program that we announced in early 2014. But in this quarter, we did begin to look at strategic alternatives for a facility and a product line within our savory flavor business. It's an ingredient product line that doesn't align well with our strategy. We think it could be a very good fit strategically for another player. And it doesn't really fit into our vision for the business going forward. So as we look at strategic alternatives for that facility and product line, we did take an impairment charge. It's about $10.3 million of non-cash expense that you will see in that restructuring-and-other line attributable to that.

Brett Hundley: I appreciate it, guys. Congratulations again.

Operator: Once again, if you would like to ask a question, please signal us by pressing star one. If there are no further questions, I will now turn the conference back to the Company for closing remarks.

Paul Manning: OK. Thank you, everyone, for your time this morning. That will conclude our call. Thank you for your interest. And if you have any follow-up questions, please feel free to call the Company following the call. Thank you.

Operator: Ladies and gentlemen, this concludes today's conference call. You may now disconnect.

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