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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Stepan Company's Third Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded today, Wednesday October 25th, 2017.

I would now like to turn the conference over to Mr. Scott Beamer, Vice President and Chief Financial Officer. Please go ahead, sir.

Scott D. Beamer - *Stepan Company - VP & CFO*

Hello, and thank you for joining Stepan Company's third quarter 2017 financial review. Before we begin, please note that information in this conference call contains forward-looking statements, which are not historical facts. These statements involve risks and uncertainties that could cause actual results to differ materially including, but not limited to, prospects of our foreign operations, global and regional economic conditions and factors detailed in our Securities and Exchange Commission filings.

Whether you're joining us online or over the phone, we encourage you to review the investor slide presentation, which we've made available at www.stepan.com under the Investor Relations section of our website. We make these slides available at approximately the same time as when the earnings release is issued and we hope that you find the information and perspectives helpful.

Now with that, I'd like to turn the call over to F. Quinn Stepan, Jr., our Chairman, President and Chief Executive Officer.

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Thank you, Scott. Good morning, and thank you all for joining our call today. Although, our third quarter net income increased versus prior year adjusted net income, adjusted net income was down due to increased competitive pressure within our North American Polymer business. Specifically, adjusted net income was $21.4 million, down $4 million versus the same quarter last year. Global polyol volumes were down slightly reflecting share loss of one customer, despite a growing market for insulation materials. Higher raw material cost in North America also contributed to the disappointing quarter for our Polymer business.

Specialty Products operating income was down following their strong second quarter due to the timing of pharmaceutical and flavor orders, which were favorable in the second quarter and unfavorable in the third quarter.

Surfactant results increased due to an improving mix and lower manufacturing costs. Both Surfactants and Polymers continue to benefit from our diversification strategy.

We announced in June that we reached an agreement with BASF to acquire its Surfactant production facility in Ecatepec, Mexico and a portion of its associated Surfactant business. The definitive agreement is subject to closing conditions and the satisfaction of certain other requirements. The transaction is now expected to close in the first quarter of 2018. We believe this acquisition significantly enhances our market position and supply capabilities for surfactants in Mexico and positions us to grow in both the consumer and functional end markets for surfactants.

Our balance sheet remains strong as our net-debt-to-total capitalization ratio further declined to 5% at quarter-end. It's the lowest level for Stepan in 8 years.

The company has generated $53 million of free cash flow during the first 9 months of the year. Our Board of Directors declared a 10% increase in the company's quarterly cash dividend on common stock, increasing the quarterly payment to $0.225 per share. This is the 50th consecutive year in which the quarterly dividend rate on the company's common stock has increased.

At this point, I would like Scott to walk through a few more details about our third quarter results.

Scott D. Beamer - *Stepan Company - VP & CFO*

Thank you, Quinn. My comments will generally follow the slide presentation. Let's start with Slide #4 to recap the quarter.

As Quinn stated, adjusted net income for the third quarter 2017 was $21.4 million or $0.92 per diluted share. In addition, adjusted net income for the first 9 months of 2017 was $84 million or $3.60 per diluted share, which is 2% below the record adjusted net income in the first 9 months of 2016. Because adjusted net income is a non-GAAP measure, we provide full reconciliations to the comparable GAAP measures and these can be found in Appendix 2 of the presentation and Table 2 of the press release.

Specifically, regarding adjustments to reported net income, this quarter included deferred compensation income of $771,000 or $0.03 per diluted share compared to deferred compensation expense of $4.1 million or $0.18 per diluted share in the same period last year. Naturally, all employee compensation expenses are reflected in our normal operating income. However, we allow employees the opportunity to defer their incentive payouts until some future date and the future payment changes based on the company's stock price. When the stock price declines, income is generated as we mark this item to market value. Because the future liability of employee compensation only changes consistently with the change in the stock price, we exclude this item from our operational discussion. The current quarter results also included $300,000 or $0.01 per diluted share of after-tax decommissioning expense related to the closure of our Canadian plant, which was announced in 2016. For decommissioning, we record expenses as incurred, as we fully wind down production at this facility. And we expect an additional $300,000 of after-tax decommissioning expense in the remainder of 2017.

Slide 5 shows the total company earnings bridge for the third quarter compared to last year's third quarter and breaks down the decrease in adjusted net income.

Because this is net income, the figures noted here are after the effect of tax.

We will cover each segment in more detail. But Surfactants were up while Polymers and Specialty Products were down versus the prior year.

Our effective tax rate was 26% for the first 9 months of 2017, compared to 27% for the same period of 2016. The favorable 100 basis point decline was attributable to tax benefits derived from stock-based compensation awards, exercised or distributed in the first 9 months of 2017 versus 2016. And an unfavorable foreign tax audit settlement recorded in 2016 that did not recur in 2017.

We believe that our full year 2017 effective tax rate will be between 26% and 28%.

Our material on Slide #6 focuses solely on the Surfactant results of the segment for this quarter. Surfactant net sales were $321.4 million, up 11% from the same quarter a year ago. Prices were 9% higher due to the pass-through of certain raw material costs. Sales volumes were up 1% mainly due to growth in higher value, strategically important areas such as Functional Products and Household Institutional and Industrial end markets and sales through our distributor partners. This increase in volume was partially offset by lower consumer product commodity volumes in North America. The positive translation impact of a weaker U.S. dollar increased sales by the remaining 1%. The segment delivered $22.5 million of operating income, a 9% increase over the prior year quarter, mainly driven by the better product mix and savings from previous restructuring actions.

In the bridge, we showed North America and Asia in the same category, because our Surfactant business in Asia is relatively small and much of the surfactant production in the region is used to support business in the U.S. North American results were positively impacted by higher demand for agriculture, oilfield and household, institutional and industrial products, as well as savings from the Canadian plant shutdown. The increase was partially offset by lower consumer product commodity sales volume compared to the same period last year.

Latin America results were up due to the Tebras/PBC acquisition as well as savings related to the shutdown of the Bahia site in Brazil. European results were down year-over-year as higher volumes did not fully offset higher raw material costs and the negative impact of a customer bankruptcy in the region.

Now turning to Polymers on Slide 7. Net sales were $147.8 million, up 10% from the same quarter a year ago. An 8% increase in selling prices was related to higher raw material cost. Sales volume was down 1% primarily due to lower global polyol and phthalic anhydride volumes, which was partially offset by higher Specialty Polyol volumes. Foreign exchange translation positively impacted net sales by 3%. Operating income was $21.1 million compared to $27.1 million in the same quarter last year. The decrease was primarily due to higher raw material cost and lower volumes in North America. Global Polyol volumes declined 1%. The decrease was primarily driven by a decline in Global Rigid Polyol volume due to lost share at 1 customer in North America. We continue to expect growing market demand due to increased insulation standards, energy conservation efforts globally and growth in construction. Our Specialty Polyol volumes increased 23% supported by the recent capacity addition in Poland.

North America results were also negatively impacted by higher raw material cost during the quarter.

While 90% of our polymer's raw material cost are based on petroleum, there are individual markets for various petroleum derivatives. Diethylene glycol or DEG is a petroleum derivative and a key raw material for our polyols. For DEG our costs were higher in the third quarter of 2017 compared to the prior year period. Although increased competitive activity in North America will persist, we have begun to recover higher raw material cost.

European results improved year-over-year due to higher volumes and slightly improved margins. Volumes were higher despite shortages of MDI, which is a component product that is reacted with a Stepan polyol to make rigid foam insulation. Also margins improved sequentially from the second quarter and were also higher than the third quarter of 2016.

In China, the results were negatively impacted by higher plant operating cost and lower export shipments.

Phthalic Anhydride results decreased over the prior year due to a 2% reduction in sales volume and lower margins.

On Slide 8, it's worth noting that at higher year-to-date free cash flow generation has enabled to further lower our net debt level, in fact to the lowest level in 8 years. This allows us to operate and grow from a position of financial strength, while continuing to return funds to our shareholders with a higher dividend rate.

Now Quinn will cover Slide 9 to update our path to further increasing shareholder value.

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Thank you, Scott. Although year-to-date adjusted net income is slightly below the record 9 months of 2016, we remain optimistic, that the company will deliver full year adjusted earnings growth.

The fourth quarter of 2017 should be higher than the prior year, as the fourth quarter of 2016 was negatively impacted by expenses that are not expected to recur.

We also believe that our diversification efforts and enhanced internal efficiencies to positively impact the fourth quarter of this year. During the third quarter, we increased asset utilization across several product lines. We expect benefits of $1.9 million in the fourth quarter of 2017, related to the transfer of production from our Canadian site to our Millsdale site, consolidation of Bahia sulfonation volumes into our Vespasiano plant and personnel reductions at our Singapore plant.

We will continue to examine our asset base for opportunities to further optimize and improve our production capacity utilization and more efficiently serve customers around the world.

Despite the quarterly decline in our volume, the Global Rigid Polyol market remains strong. And projects to enhance polyol production for the rigid insulation market at our Millsdale and Wesseling sites are underway. Production from our new specialty polyol reactor in Poland, which began production last fall, contributed to the 23% increase in global specialty polyol volume during the quarter. A new specialty polyol reactor in Columbus, Georgia, will begin production earlier next year.

For the full year, we expect company capital expenditures to be between $85 million and $95 million, which is slightly lower than our previous expectation of $95 million to $105 million.

We're committed to deliver profitable growth in new geographies, CASE polyols, functional surfactants in Tier 2, Tier 3 consumer product customers. We continue to make inroads in hydraulic fracking with new surfactant technologies as the oil market slowly recovers. Our acquisition of Tebras/PBC in Brazil is ahead of plan. Our intention to acquire a Surfactant plant in Mexico early next year, supports the company's growth strategy in Latin America.

Our internal operation efficiency program called DRIVE continues to help the company reduce costs, improve margins and increase the capacity of our production assets. We remain on track to achieve $15 million of pretax cash cost out for the full year.

In Polymers, although increased competitive active North America will persist, we have begun to recover higher raw material cost within the polyol market segment and will continue to benefit from the growing global market volumes for insulation materials. Our path to increase shareholder value should continue to advance and we're optimistic that earnings for the year should grow.

This concludes our prepared remarks. At this time, we would like to turn the call over for questions.

Colin, please review the instructions for the question portion of today's call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Mike Harrison with Seaport Global Securities.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

Quinn, you called out the customer loss in North America in the Polymers business and then also cited competitive pressures. But it sounds like you expect these competitive pressures to persist. So is it just that we're seeing continued drag from that 1 customer loss? Are there are additional customers or additional maybe price concessions that you're going to need to be making as we move forward?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Yes, I mean we live in a competitive market today and there is always competition. Having said that, our polyol volumes were down slightly. With the exception of the 1 customer, all other polyol volumes were up on a global basis. So we do see some increased competitive activity on a price basis, more in North America than in Europe. We believe there may be a little bit more price competition as we enter 2018, but the fundamental market for our polyols for insulation materials overall continues to be very strong on a global basis. So our volume may have reset a little bit, but we are still very excited, enthusiastic about our polymer business on a global basis.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

All right. And then just curious. Was this good business that you guys lost or more kind of low margin business that you could almost view as you walked away from it because you weren't going to chase the price lower? And also just wondering if you could talk more broadly on how you win business in Polymers? Is it related to product performance, is it service, is it price, or is it something else that drives why you win business or lose business?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

So we have a very strong market position for rigid polyols, particularly in North America and in Europe. We compete very strongly on the quality of our products. The advantages that they typically have in our customers' facilities that allow them to process our material effectively and efficiently. We have an extensive technical service group around the world that helps our customers start up their facilities and then to ensure that their facilities are running effectively and efficiently. So we lead with our technology in the polyol space. And we believe we offer our customers significant cost performance advantages with the whole package that we offer today.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

All right. In terms of the specific customer that you lost, was it good business or was it more?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Yes. I would say, generally speaking, all the business within the Rigid segment is good business. We don't want to lose any business in those marketplaces. So we will continue trying to defend and recapture our share on a global basis, but the business itself is good business.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

Got it. Moving over to Surfactants, you noted the lower consumer sales in North America. I know that's not a great growth business. But is there something specific that was driving the decline? And just wondering how much that weighed on the overall volume performance in Surfactants?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Large consumer product companies around the world continue to look at the components that they are offering within the laundry bottle, within the laundry box or within the shampoos, products. Those companies are under tremendous pressure to increase their profitability and they can continue to look at their formulations. So Surfactants as being a large percent of their cost remain opportunities to be deformulated or reformulated out of their products because they are such a large percent of their total cost. So that's what we've been seeing over the last several years. The laundry products today contain about 40% less surfactants in a laundry product due to again reformulation and then deformulation, than they did 10 years ago. So that trend we believe will continue to occur, albeit, it has slowed significantly in North American and Western Europe. That is partially offset by growing markets in the emerging parts of the world.

Scott D. Beamer - *Stepan Company - VP & CFO*

And therefore, Mike, I would only add that it is strategically important areas that we talk about with functional products, Distributors, Household, Institutional and Industrial and then those Tier 2 and Tier 3 customers, where there is less of the situation that Quinn just mentioned in terms of our Tier 1 customers generally focused on the cost and what's in the bottle and so on. Thus the strategy that we present in trying to focus and grow in those other areas.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

Right, right. Got it. Speaking of the functional in HI&I businesses, those continue to do pretty well. Just wondering if you can comment on the outlook that you're seeing in those areas, particularly AG and oilfield as we head into 2018? And then, is that momentum likely to continue based on your efforts, that you have in place to try and grow in those more specialized products and with those Tier 2 and Tier 3 customers?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

I would say -- let me talk about the HI&I market first. The HI&I market, as the economy improves, that market grows. As people use restaurants more often, go out to hotels, that segment of the market improves. That market also is dependent upon schools and hospital disinfection. And there is greater concern about these in public places today, so the amount of disinfectants and antimicrobials continues to grow, not only in the United States but around the world. And that business for us is, we have a few very large customers, but we have a very fragmented diverse customer base. So that allows us to provide a full basket of products to customers in that space that generally is favorable to us. So we feel pretty good about our position in the Household, Industrial and Institutional cleaning market. We talked about the AG market. Stepan again has a very strong technical presence in the agricultural space, where we're working very closely with our customers on the development of their next generation introduction -- market introductions into the agricultural space. The digestion time for new products in the agricultural space can be as long as 5 years. So based on things that are in the pipeline, that our customers are planning on introducing in 2018 and 2019, we see a fair amount of growth in our business over the next 2 years. So we're pretty well positioned to continue to grow in that space. The amount of agricultural pesticide, herbicides that the farmer uses with higher -- if we get higher crop prices would be a further benefit to that business. So generally we feel pretty good about the AG space. We have a relatively small market position in Oilfield today. That's a good thing because it gives us an opportunity to demonstrate that we can, if you will, solve -- help our customers solve problems and bring solutions to the surface. And so we've got a range of new products for hydraulic fracturing and other applications that are starting to increase their penetration in the marketplace. And we feel like we're positioned for growth in that marketplace in 2018 and beyond.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

All right. And then last one for now and I will turn it back. You mentioned the customer bankruptcy impact in the European Surfactants business. Can you quantify how much that impacted you this quarter?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

About $800,000.

Scott D. Beamer - *Stepan Company - VP & CFO*

Yes, it was about $800,000, Mike. And the customer was current with us. All the outside information that we used to assess our risk profile with our customers, that was all positive. So this one was a bit of surprise for us. Fundamentally, we're typically in a really good position from a customer bankruptcy perspective in terms of the mix of customers that we have and the financial strength of them. So this one was a surprise. It was about $800,000 for the quarter.

Operator

(Operator Instructions) Our next question comes from the line of David Stratton with Great Lakes Review.

David Michael Stratton - *Great Lakes Review - Research Analyst*

When we look at the global Surfactant volume increase of 1% and then put that against the lower commodity Surfactant demand. Is that an overall shift? Or you gaining share in a certain segment? Or can you give a little more granularity around that?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

I would say, going back to the last question, we're experiencing growth in HI&I, AG and Oilfields and through our distribution partners. And that growth is partially offset by declining volumes at the large multinational consumer product companies.

David Michael Stratton - *Great Lakes Review - Research Analyst*

And with your business with gypsum companies, gypsum board be included in the HI&I?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

No, that would be in the Functional Surfactant area. And that is an important market for us. It's a market that we again have lead with the technology offering that allows the customers to make a lighter, stronger gypsum board. And we have a nice position in that market on a global basis. Again, helping our customers implement those technologies -- our technologies on their lines. And it's a niche -- relatively small market for Surfactants, but it's an important one for Stepan Company.

David Michael Stratton - *Great Lakes Review - Research Analyst*

And it seems that's benefiting from all the storm damage in the South that has occurred?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

Yes, I would say not yet. I think for the most part they have been able to utilize existing inventories or deplete existing inventories in the space. But we would anticipate that we would get a little bit of bump in the gypsum market as well as in the insulation market, as we get into 2018 due to the hurricanes and storms.

David Michael Stratton - *Great Lakes Review - Research Analyst*

Got you. And then can you break out the customer bankruptcy on an EPS basis? About what the impact was?

Scott D. Beamer - *Stepan Company - VP & CFO*

So, let's say, $800,000, David, on a pretax basis, 500 or so after-tax, so 500, I'm going to grab the calculator here a minute, just to make sure I get it to you. But 500 on $22.3 million, it's about.

Scott D. Beamer - *Stepan Company - VP & CFO*

$0.02.

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

$0.02.

David Michael Stratton - *Great Lakes Review - Research Analyst*

I just wanted to make sure there wasn't some tax accounting that I was miscalculating.

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

No, no.

Operator

Our next question comes from the line of Curt Siegmeyer with KeyBanc.

Curtis Alan Siegmeyer - *KeyBanc Capital Markets Inc., Research Division - Associate*

Just a question on your operating income bridge for the Polymers segment. Obviously, the North American Polyols is the biggest piece of -- in terms of the headwind. And I know you said pricing pressure you expect to kind of continue at least in the near term. But do you anticipate being able to sort of close that gap on that? Or do you think, is there going to be an issue with this -- with the lost customer, where until we lap that lost customer in next year?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

As we look at our business sequentially during the month, the shortfall kind of shrank as -- during the quarter as the month proceeded. We generally don't talk about LIFO. But there was a significant unfavorable LIFO effect in the third quarter relative to our Polymer business that we're not anticipating to reoccur in the fourth quarter. So that will help us kind of close that gap a little bit further, relative to our performance. We said at last quarter, and we were wrong, but we had anticipate that our Polymer business will approximate the fourth quarter of last year in this current quarter.

Scott D. Beamer - *Stepan Company - VP & CFO*

Yes. Exactly right. We mentioned, we were wrong. So we had said when we met last time, we expected the second half of the year to be on prior year. We were obviously wrong about the third quarter. We are reiterating the point for the fourth quarter here, Curt, that we believe the Polymer earnings will be up to prior year levels in the fourth quarter.

Curtis Alan Siegmeyer - *KeyBanc Capital Markets Inc., Research Division - Associate*

Got it. And then just on the topic of fourth quarter more on a corporate level. When you think about price cost, you guys have been taking price increases. You're still seeing the pressure on margins overall. Do you anticipate that being closer to neutral in 4Q? Or should we anticipate relative to last year some incremental margin pressure?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

We anticipate that in our Polymer business that our margins will still be less than last year, better than in Q3, but less than 2016. In our Surfactant business, we anticipate a potentially a slight improvement in our margins in Q4.

Operator

Our next question comes as a follow-up from the line of Mike Harrison with Seaport Global Securities.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

With regard to the Polymers business, you mentioned that the MDI shortages persisted in Europe, but that you still saw volumes improve there. Can you just talk about whether have the MDI shortages run their course at this point? And have you kind of weathered any concern. I guess concern I had was that maybe we look to other insulation materials other than rigid foam if we have shortages out there. Did any of that share loss happen? Or has that all kind of come to pass?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

So, one, I would say that the shortage of MDI is mostly behind us, barring another event, but is mostly behind us. It impacted -- specifically in Europe and impacted our customers. There was some share loss specifically to phenolic foam during that period because MDI was not available. So we anticipate recapture of that business going forward. And so we would anticipate the market for MDI would remain tight but not a barrier to growth in 2018.

Michael Joseph Harrison - *Seaport Global Securities LLC, Research Division - MD & Senior Chemicals Analyst*

And then with regard to the BASF acquisition in Mexico. Just curious whether that facility was impacted by the earthquake and kind of, if there is any change in how you are thinking about that business?

F. Quinn Stepan - *Stepan Company - Chairman, President & CEO*

You would have to ask BASF if they thought there was an impact because it's their facility. So I don't want to speculate on that. But we're still excited about the opportunity to buy this site. And we're working with them to close on that acquisition in Q1.

Operator

And there appears to be no further questions on the phone. So Mr. Beamer, I will now turn the presentation back to you. You may continue with your presentation or closing remarks.

Scott D. Beamer - *Stepan Company - VP & CFO*

Thank you very much for joining us on today's call. We appreciate your interest and ownership in Stepan Company. We look forward to reporting our full year results to you in February. Thank you. Have a great day.

Operator

And ladies and gentlemen, that does conclude the conference call for today. We thank you all for your participation. You are now free to disconnect your lines.