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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Second Quarter 2018 Earnings Call. (Operator Instructions) As a reminder, this conference is being recorded, Wednesday, July 25, 2018.

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

Luis E. Rojo - *Stepan Company - VP & CFO*

Good morning, and thank you for joining the Stepan Company's second quarter 2018 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 for our foreign operations, global and regional economic conditions and factors detailed in our Securities and Exchange Commission filings.

Whether you are joining us online or over the phone, we encourage you to review the investor slide presentation, which we have 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 information and perspectives helpful.

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

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

Thank you, Luis. And welcome to your first Stepan Company earnings call and good morning to you all and thank you for joining us today.

Stepan Company had a good second quarter, delivering record reported and adjusted net income for both the quarter and the first half of 2018. Second quarter and first half adjusted net income were $32.1 million and $64.1 million, respectively, up 4% and 2% from the prior year period. These results were driven by record first half Surfactant earnings and a lower 2018 effective tax rate.

For the quarter, Surfactant operating income increased 10% over the prior year due to strong North American demand within both the consumer and functional end markets.

The Polymer business improved versus first quarter results despite margin and share challenges in our North American polyol business, which we have previously communicated.

The European polyol volumes matched prior year levels, while both global specialty polyols and China delivered earnings growth.

Our Specialty Product business results were down, partially due to changing order patterns, but we still anticipate full year income improvement from this segment.

Our Board of Directors declared a quarterly cash dividend on Stepan's common stock of $0.225 per share payable on September 14, 2018.

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

Luis E. Rojo - *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 has stated, adjusted net income for the second quarter 2018 was $32.1 million or $1.38 per diluted share, a 4% increase versus $30.9 million or $1.32 per diluted share in the second quarter of 2017. 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, adjustments to reported net income this quarter consists of adjustment for deferred compensation income and restructuring expense. Adjusted net income for the quarter excludes the deferred compensation income of $1 million or $0.04 per diluted share compared to deferred compensation expenses of $2.5 million or $0.11 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 increases, expense 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 adjusted net income also excluded $200,000 or $0.01 per diluted share of after-tax business restructuring charges. These charges related to decommissioning costs from the closure of our Canadian plant, which we announced in 2016. We expect an additional $1 million to $2 million of after-tax restructuring charges in 2018 related to decommissioning costs at both our Canadian and Fieldsboro plants.

Slide #5 shows that total company earnings bridge for the second quarter compared to last year's second quarter and breaks down the increase in adjusted net income. Because this is net income, the figures noted here are on an after-tax basis. We will cover each segment in more detail, but Surfactants was up, while Polymers and Specialty Products were down versus the prior year.

The company's effective tax rate was 20.6% for the first half of 2018 versus 26.5% for the first half of 2017. The decrease was mainly due to our lower U.S. statutory tax rate of 21% in the first half of 2018 versus 35% in the first half of 2017.

We expect the full year effective tax rate to be in the range of 20% to 23% in 2018.

Slide #6 focus on the Surfactant segment results for the second quarter. Surfactant net sales were $357 million, up 8% from the same quarter a year ago. Volume increased 7%, while average selling prices increased 1%, mostly due to the pass-through of certain raw material costs. Excluding the first quarter acquisition in Mexico, net sales increased 5%, while sales volume increased 3%. Organic volume growth was mainly due to higher North America Consumer Product and Oilfield volumes. Higher sales volume to our distribution partners in North America also contributed to this increase. The segment's operating income increased $3.1 million or 10% versus the prior year primarily due to strong demand in North America.

In the bridge, we show North America and Asia in the same category because our Surfactant business in Asia is relatively small and most of the surfactant production in that region is used to support business in the United States.

Latin America results were down primarily due to higher feedstock and other transition costs from the first quarter acquisition in Mexico. We continue to believe that the acquisition should be slightly accretive for the year. Brazil, operating income decreased due to lower Consumer Product commodity sales volume.

European results were higher primarily due to improved margins.

Now turning to Polymers on Slide #7. Net sales for the quarter were $141 million, essentially flat versus the comparable prior year period. Total sales volume increased 1%, despite a 1% decline in global polyol volumes. The positive foreign currency translation impact of a weaker U.S. dollar increased sales by 2%.

Operating income was $19.5 million for the quarter versus $21.3 million in the same quarter last year. Operating income was down due to a less favorable product mix and margin pressures. Global Polyol volumes were down 1% driven by the share loss in North America. This was partially offset by higher Specialty Polyol volumes supported by the new reactor in Columbus, Georgia and benefits from continued Rigid Polyol market growth.

European volumes matched prior year levels. We believe the market for insulation materials remains strong due to continued global energy conservation efforts.

Operating income in North America was also negatively impacted by higher raw material costs during the quarter. European margins improved from the first quarter of 2018.

Phthalic Anhydride, or PA, results increased due to higher sales volume. A scheduled PA maintenance turnaround will negatively impact the fourth quarter of 2018.

Specialty Product Operating Income was $4.2 million for the quarter, a decrease of $1.2 million versus the prior year quarter, primarily due to a less profitable product mix in the food and nutritional business and anticipated order timing differences within the flavor business.

Turning to Slide #8. Our balance sheet remains strong as our net debt remains low at 4%. The company generated $31.4 million of free cash flow during the second quarter, which represents free cash flow conversion of 99%. We returned $14.6 million to our shareholders during the quarter via dividends and share repurchases.

Beginning on Slide #9, Quinn will now update you on our plan to increase shareholder value.

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

Thank you, Luis. After achieving record first half net income, we remain optimistic about the balance of the year. We believe our Surfactant business will continue to build upon its strong start and benefit from our diversification efforts into functional products, new technologies, improved internal efficiencies and expanded sales into our broad customer base globally. Although we expect that margins will continue to challenge our North American Polymer business, we are optimistic about additional volume opportunities during the second half. We believe full year Specialty Product results should improve over 2017.

Turning to Slide #10. Our leadership position as the largest producer of anionic and amphoteric surfactants for the merchant markets in the Western Hemisphere was strengthened with the BASF Ecatepec acquisition. Although the acquisition did not contribute to the earnings growth for the quarter, it should be slightly accretive for the full year. The acquisition, including sales and cost synergies, should contribute between $4 million and $6 million operating income in 2019.

Overall, the company's commodities Surfactant sales volume grew significantly in the quarter driven by strong performance by our North American Consumer Product group, partially offset by lower Brazilian volume. We expect that commodity Surfactant volumes for the balance of the year should remain strong. Despite previously mentioned headwinds in our Rigid Polyol business, we remain optimistic about the continued growth of the market due to increased insulation standards, continued energy conservation efforts and the expected growth in construction.

We believe that opportunities for our Global Rigid Polyol business in the second half should mostly offset lower margins, as we have substantially recaptured previously lost Polyol share for the balance of 2018. We still believe that Global Rigid volumes in the second half of 2018 should meet or even exceed volume shipped in the second half of 2017.

Our diversification efforts continue to be a key component of our long-term strategy. In the Oilfield market, we continue to believe that Stepan's portfolio of Surfactant chemistries is well suited for use in the production of oil. Our strategy to expand the Tier 2 and Tier 3 segment to reach and acquire more new customers remains a top priority for our Surfactant team. For the first half of the year, volume from our diversification efforts was up 10% with strong performance from our Oilfield segment and our Tier 2 and Tier 3 Consumer Product customers. We believe that our diversification efforts should also continue to contribute to our earnings growth for the balance of 2018.

We remain optimistic about the growth of our CASE Polyol business. Sales volume in North America increased 6% supported by the new specialty polyol reactor in Columbus, Georgia.

Collaborative chemistry is a key foundationof our long-term strategy. As a leader in the Rigid Polyol market, we continue to work on developing the next generation of value-added technologies for our customer base and are excited about a few advances in our research pipeline. We recently launched a new solvent for the personal care end-market and developed patent-pending technology for use in fracking oil wells.

Our focus on operational excellence also remains a key aspect of our strategy. The restructure of our Fieldsboro, New Jersey plant is expected to deliver savings this year. We believe the application of sulfonation and best practices, network synergies and DRIVE opportunities will create value from our Ecatepec acquisition.

Finally, we delivered a record quarter and record first half results of both reported and adjusted net income. We have also returned $22.5 million to our shareholders via dividends and share repurchases thus far this year. We clearly are positioned well to capture opportunities for you, our shareholders, for the remainder of the year.

This concludes our prepared remarks. At this time, we'd like to turn the call over for questions. Cathy, please review the instructions for the question portion of today's call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of David Stratton from Great Lakes Review.

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

I was wondering about -- you mentioned a substantial share recapture in the North American Polyol volume. I was wondering if you could elaborate a little bit about that and just tell us the dynamics that you're seeing currently?

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

I believe, I said we have substantially recaptured our share that we'd previously lost for the balance of 2018. So if we look at our share in the marketplace, we have virtually recaptured everything that we previously lost in North America for the balance of 2018.

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

And has that been a result of competitors changing their strategy? Or is that a result of you guys really going after that share?

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

I would say it's -- we were working with our customers, and we were able to replace that lost share. it's a competitive market and we're always willing to be competitive, and we were able to regain that share.

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

Excellent. And then regarding the Latin American Surfactants. I was wondering if you could give us a little bit more color about what you're seeing in that market, especially the puts and takes when you look at -- you're pushing the Tier 2 and Tier 3 and then some of the softness that you're seeing?

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

Yes. Let me start with -- we've highlighted that our commodity Surfactant volume is down in Brazil. We've seen a reformulation that occurred in 2017. And now in 2018, where some surfactant has been replacing formulations by polymers. So we believe and we've been told that that's kind of the end of the reformulation activity related to the polymers in that marketplace, so our volumes on the commodity end of the product portfolio are down. We continue to be excited about the Tier 2 and Tier 3 opportunities and that's specific in Brazil. And we are selling additional volume to our customer base down there through our Tebras acquisition 2 years ago. We continue to be pleased with that. That historically is focused on the Laundry and the HI&I market, and we're also using that sales force to expand our presence in the personal care market. So from a Tier 2, Tier 3 customer base in Brazil, we continue to make progress and are pleased with that. If you take a step back and look at other markets in Latin America, certainly, we have a new asset in Mexico that we're very excited about. Since the acquisition, we have brought new volume both in terms of anionic surfactant and amphoteric surfactants and the market has well received our standard position in the Mexican marketplace. And we believe there are going to be future opportunities for volume growth and profit growth in that marketplace.

Operator

(Operator Instructions) And our next question comes from the line of Mike Morales with Walthausen & Co.

Michael Morales - *WaltHausen Co. - Analyst*

I was hoping for a little bit more color on the margin pressures that we're seeing in North American polymers. We called out the raw material costs. Are there other elements that are contributing to that as well?

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

I think we've highlighted throughout the last half of 2017 and '18 that we did see some increased competitive activity in the space. So we've seen some movement by some competitors to try to capture share, and they gave some financial incentives to do that to customers and that's where we're at today.

Michael Morales - *WaltHausen Co. - Analyst*

All right. And then the volumes that we recapture for the share that we've lost, was that coming from share gains with new customers, existing customer volumes? Can we get some color on that?

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

In the North American market, rigid polyols is a relatively small customer base--, there have been no significant new entries in that space over a number of years. So we captured share within our existing customer base.

Michael Morales - *WaltHausen Co. - Analyst*

Got it. And then maybe, shifting gears a little bit. Have we heard of any problems on the North American MDI supply at this point?

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

Yes. So [DowDuPont] has declared force majeure on their MDI in North America. Most of their MDI is used captively to support their urethane systems business. They do have a presence in the merchant market. But not a large presence in the rigid polyol marketplace. So we've reached out and checked with our customers, none of them believe they're going to have any significant impact from the force majeure in the marketplace today.

Michael Morales - *WaltHausen Co. - Analyst*

Got you. Then just to clarify our expectation for the higher volumes in North American polymers that is -- taking into account the supply headwind coming on the force majeure there?

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

Yes. And again, checking with our customers and specifically with the customer here we have increased that share, they do not anticipate any impact to their business.

Operator

(Operator Instructions) And our next question comes from the line of Curt Siegmeyer from KeyBanc Capital Markets.

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

Can you just comment, maybe, how much of the new reactor contributed to volumes for the Polymer business in the quarter? And then your outlook for that business going forward, given your optimism that you commented on around volume opportunities in the rigid polyol business in the second half? Just what sort of confidence do you have in those opportunities?

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

I think CASE volumes in North America were up 6%. I believe in the second quarter, they were up 6%. So as we looked at the year going forward, we would anticipate similar type contributions from that as we approve additional volumes or get approvals from additional volumes and customers that we would anticipate that we would have kind of 6% or so growth for the balance of the year in that end market. So that's really what we're talking about -- that level of growth.

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

Got it. Okay. And then on the Surfactant business with -- related to the acquisition in Mexico, you commented on the higher feedstock and supply chain transition costs and the impact that, that had in the quarter. Do you anticipate that being a headwind again in the third quarter? And just sort of how we should think about that in the second half?

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

So we have lost a small amount of money in the first half of the year. We've said that this will be slightly accretive in the second half. So we would be looking at positive contributions in Q3 and growing in Q4 relative to this business. Not significantly -- overall, not significant impact for 2018. And I mentioned that we would anticipate $4 million to $6 million of operating income in 2019.

Operator

And our next question comes from the line of Christopher Hillary with -- at Roubaix Capital.

Christopher Edmund Hillary - *Roubaix Capital, LLC - CEO and Portfolio Manager*

I just wanted to ask your -- you highlighted in your slides that the low level of net debt and you're obviously completing an acquisition. Can you just discuss what opportunities you see to deploy the balance sheet? And are there more or less opportunities than you've been seeing in the recent past to do things that would benefit the business?

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

Certainly, if you take a step back and look at the chemical industry, the multiples in the chemical industry for acquisitions are relatively high today. So there are a number of particularly, private equity companies that are looking to potentially exit a number of their investments that they've made. So relative to the volume of opportunities that are available today in the marketplace and that are being presented to us, the volume, I would say, is up significantly over the last 12 months. And we continue to look and screen opportunities as we would like to be more acquisitive, but we want to make sure that we're buying something that is consistent with our long-term strategy and that we're paying a fair value for. So we are looking at a number of things, and we'd like to put some of that money to work. We did see that we increased our share repurchases in the second quarter, again, trying to put some of that money to work, and we would anticipate some additional share purchases or repurchases for the balance of the year as well.

Christopher Edmund Hillary - *Roubaix Capital, LLC - CEO and Portfolio Manager*

Okay. Then, maybe, just a similar question, but a different angle. Are there any projects that you might find compelling in terms of capital expenditures to either improve your productivity or enter new markets?

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

We commented in the past that we continue to look at the anionic surfactant space and it's specifically putting in a significant investment on the Gulf Coast of the United States. So that remains a priority and something that we're actively working on in terms of organic opportunity to make an investment. We can comment in the future on that.

Operator

And there are no other questions at this time. I'll turn the call back over to you for any closing remarks.

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

Okay. Well, thank you all for joining us on today's call. We appreciate your interest and your ownership in Stepan Company. We look forward to reporting to you on our third quarter 2018 conference call. Have a great day. Thank you.

Operator

Thank you. Ladies and gentlemen, that does conclude the call for today. We thank you for your participation and ask that you please disconnect your lines. Have a great day.