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SCL - Q1 2018 Stepan Co Earnings Call

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. And welcome to the first quarter 2018 earnings conference call. (Operator Instructions) As a reminder, today's conference is being recorded, Tuesday, April 24, 2018.

It is now my pleasure to turn the conference over to Matthew Eaken, Vice President, Corporate Controller and Interim Chief Financial Officer. Please go ahead.

Matthew John Eaken - *Stepan Company - VP, Corporate Controller & Interim CFO*

Good morning, and thank you for joining Stepan Company's First 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 risk 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 the information and perspectives helpful.

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

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

Thank you, Matt. Good morning, and thank you all for joining our call today. Stepan Company had a good start to the year. First quarter adjusted net income was a record, just barely at $32 million, up 1% from the prior year quarter. The good start was driven by record Surfactant results. For the quarter, Surfactant operating income increased over prior year due to an improved product mix improved internal efficiencies and the stabilization of commodity Surfactant volumes. We closed on the acquisition of BASF surfactant production facility in Ecatepec, Mexico, on March 26. The company believes the acquisition enhances our market position and supply capabilities for surfactants in Mexico and positions the company to grow in both the consumer and Functional end markets in Mexico and adjacent geographies. The acquisition is expected to be slightly accretive to earnings in 2018.

Our North American Polymer business continued to face headwinds related to lost share and lower margins previously communicated. In Europe, the Polymer business was negatively impacted by the lingering effect of the 2017 MDI shortage and extended winter weather. Despite a disappointing quarter for our Polymer business, the market for insulation materials remains attractive due to continued global energy conservation efforts. Our

Specialty Products business results were down due to changing order patterns for our pharmaceutical and flavor customers. However, Specialty Product results for the full year should improve over 2017.

Our Board of Directors declared a quarterly cash dividend on Stepan's common stock of $0.225 per share payable on June 15, 2018. At this point, I'd like Matt to walk through a few more details about our first quarter results.

Matthew John Eaken - *Stepan Company - VP, Corporate Controller & Interim 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 first quarter 2018 was $32 million or $1.37 per diluted share, a 1% increase versus $31.7 million or $1.36 per diluted share in the first 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, regarding adjustments to reported net income, this quarter included deferred compensation expense of $1 million or $0.05 per diluted share, compared to deferred compensation income of $800,000 or $0.03 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 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 business restructuring charges. These charges related to decommissioning costs from the closure of our Canadian plant 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 the total company earnings bridge for the first quarter compared to last year's first 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 18.4% for the first quarter of 2018 versus 28% for the first quarter of 2017. The decrease was primarily attributable to higher excess tax benefits derived from stock-based compensation awards and the net impact of the lower U.S. statutory tax rate of 21% in the first quarter of 2018 versus 35% in the first quarter of 2017. The 2017 U.S. Tax Reform Act favorably benefited the current year quarter by $800,000. We continue to expect the full year effective tax rate to be in the range of 20% to 23% in 2018.

Our material on Slide #6 focuses solely on Surfactant segment results for the first quarter. Surfactant net sales were $358.9 million, up 11% from the same quarter a year ago. Selling prices were 4% higher, mostly due to the pass-through of certain raw material costs. Sales volumes were up 4%, mainly due to higher North American and European Consumer Product, Agricultural and Oilfield volumes.

Higher sales volume to our distribution partners in North America also contributed to this increase. The positive translation impact of a weaker U.S. dollar increased sales by the remaining 3%. The segment delivered a record $40.3 million of operating income, a 5% increase over the prior year quarter.

In the bridge, we show North America and Asia in the same category because our Surfactant business in Asia is relatively small and much of the surfactant production in that region is used to support business in the United States. North American results were positively impacted by higher demand for Personal Care and sales through our distribution partners. Latin American results were down, primarily due to lower commodity Consumer Product sales volume in Mexico due to high year-end inventory balances of Tier 1 customers and higher expenses associated with the first quarter acquisition of Mexico.

Brazil operating income was down slightly despite growth in the Tier 2 and Tier 3 customer base. European results were higher year-over-year, due to strong Consumer Products demand and growth in Agricultural Chemicals.

Now turning to Polymers on Slide #7. Net sales were $121.9 million, down 4% from the same quarter a year ago. Sales volume decreased 9%, primarily due to lower North American and European polyol volumes used in rigid foam insulation and insulated metal panels. This volume shortfall reflects the lower customer demand due to adverse winter weather that delayed project starts, lost share in North America and the lingering effects of the 2017 MDI shortfall in Europe. Fundamentally, the market for insulation materials remains strong due to continued global energy conservation efforts. The positive translation impact of a weaker U.S. dollar increased sales by the remaining 5%. Operating income was $16.9 million compared to $21.4 million in the same quarter last year. Global polyol volumes were down 10% due to share loss in North America and soft demand in Europe as discussed previously. Operating income in North America was also negatively impacted by higher raw material costs during the quarter, partially offset by $2.1 million of proceeds from a favorable class action settlement. The decline in European sales volume was partially offset by the recapture of lost margins from higher raw material costs.

Turning to Slide #8. Our balance sheet remains strong as our net debt remains low at 6%. The company consumed $34 million of free cash flow during the quarter, primarily due to the first quarter acquisition in Mexico and higher working capital requirements. Higher working capital requirements are typical for the company in the first quarter.

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, Matt. Looking forward, we believe our Surfactant business has momentum and 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 to our broad Consumer Product customer base globally. However, headwinds in our North American Polymer business will continue to challenge us in 2018. Better European weather is expected to restore demand for insulation and contribute to improved polymer results. Overall, we are optimistic about the balance of the year.

Turning to Slide 10. We believe that our market leadership position in several of our businesses is a strong foundation from which we can continue to grow. Our position as the largest producer of anionic and amphoteric surfactants for the merchant market in the Western Hemisphere was strengthened with the acquisition of the BASF plant in Ecatepec, Mexico. Although the acquisition did not contribute to the earnings growth for the quarter, it should be slightly accretive for the full year. Overall, company anionic surfactant sales volume grew for the quarter, a performance we look to sustain in the Americas during the remainder of the year. As previously mentioned, we are currently experiencing headwinds in our rigid Polyol business. However, as a leading producer of rigid polyester polyols globally, 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. For the remainder of the year, we believe that global rigid polyol volumes should approximate 2017 despite share loss in North America.

Our diversification efforts continue to be a key component of our long-term strategy. We continue to work very closely with many large agricultural companies to include Stepan chemistries in their product launches. 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 segments to reach and acquire more new customers remains a top priority for our Surfactant team. For the quarter, contributions from our diversification efforts increased significantly and should continue to do so for the balance of 2018.

We remain optimistic about the growth of our CASE Polyol business. Although European demand was soft for the quarter, sales volume in North America increased 3% supported by the new specialty polyol reactor in Columbus, Georgia.

Collaborative chemistry is a key foundation of 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 the few advances in our research pipeline. We also continue to create more biodegradable and bio-based solvent chemistries for the Agriculture market. 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 that the application of sulfonation best practices, network synergies and DRIVE opportunities will create value from our Ecatepec acquisition.

Finally, we delivered another record quarter of adjusted net income. The market provides challenges and opportunities. We feel we are positioned well to capture opportunities for you, our shareholders. This concludes our prepared remarks. At this time, we would like to turn the call over for questions. Tina, please review the instructions for the question portion of today's call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Mike Harrison, Seaport Global Securities.

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

Wanted to start on the Surfactant's business. I was just hoping for a little more color on what you're seeing in the commodity or consumer side of surfactants? I think that I heard you say you were seeing some stabilization there broadly, and I wasn't sure if that was just a North America comment. And can you specifically address the issues that you saw in Latin America in some of the consumer Surfactants? Wondering if that's just a temporary inventory issue there? Or if we can see some lingering issues into the second quarter?

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

You are correct that the stabilization of the commodity anionic volume is primarily driven by our North American business. Our anionic business, in fact, was up 1.5% for the quarter with one large customer, actually, being down a little bit. So we're encouraged by the growth in the North American market and are optimistic that, that growth will continue for the balance of the year. With respect to Latin America specifically, we had some customers carry some large inventories of fabric softeners into 2018, so our business was down further in January and February associated with that. So we anticipate that business will pick up for the balance of the year.

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

Okay. And in terms of the impact of acquisition costs in Latin America during the first quarter. How much expense was in the first quarter results that you did not treat as onetime?

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

Yes, Mike. And that was probably in the range of, I mean, all-inclusive say the $1 million thereabouts. And then that's partially split between North America results and Latin America results.

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

All right. So if I think about the go-forward margin performance though, it would have been better, excluding that unusual impact?

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

That's correct.

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

Okay. And then, switching over to the Polymers business. It seems like you're still relatively optimistic on polymers demand. I believe I heard you say that you expect volumes for the full year to end up about where they were for 2017, even though you're starting in a -- with a negative 9% number. But can you just walk through kind of the...

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

That's not exactly what I said, Mike. What I said was that we believe volumes for the balance of the year will approximate 2017.

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

Okay. That's an important clarification. But maybe just thinking about the underlying fundamentals of the business, can you walk through region by region, whether you're still seeing kind of the secular- and regulatory-driven growth that's been helping that business over the past several years?

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

Yes. The short answer is yes, we are. And we do believe that the market is continuing to grow at 6% to 7% per year. And what we're seeing is that the growth in the market at least for the balance of the year will offset the share loss that we've had in North America. So we still feel very good and comfortable that the market is strong and growing and -- so we feel good about that.

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

All right. And in terms of the competitive environment and kind of the way I think about pricing and volume right now, Are you facing some situations now where you've decided to hold the line on pricing? And it's meant that you've had to walk away from some volume as a result? Kind of how are you treading that line?

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

I would say a couple of comments. One, the businesses are generally awarded in North America on an annual basis. We have contracts in place for our business for the balance of 2018. So we have a certain amount of knowledge in terms of what our business is going to look like for the balance of the year. And the growth that we're anticipating is going to come from growth in the market and not necessarily additional pickup in share. And -- so I would say that we're competitive in the marketplace today, and our intent is to continue to provide value for our customers.

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

And then last question for me is, you commented that you're still seeing some lingering effects of the MDI shortage in Europe. Was just wondering, is this a situation where you've seen lingering substitution of other competitive products that are not rigid foam insulation or not using your polymer products?

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

Yes. I would say it's twofold. One, availability of MDI became available in November, December of last year. Customers that have been short throughout the year bought MDI and filled their inventories. So many of our customers in Europe came into the year with fairly large inventories and then with the difficult weather that Europe experienced in the first quarter, they did not buy as much. So there was the high inventory going into the year. But you're exactly right that during the MDI shortage last year, as people were specifying insulation for projects because PIR insulation was not available, that PIR insulation may have lost some share. And so that is playing itself out right now. And we'll have a better feel in the May, June time frame to see how much market share loss that there was.

Operator

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

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

When I look at the BASF facility you just acquired, now you mentioned some opportunities there to improve best practice and synergies and then also some DRIVE improvements? Are you able to quantify what you expect going forward? And the pace at which you expect to realize those?

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

I -- we've only owned this site at this point for 2.5 weeks. What I would ask is that if you could ask that question at the end of the next quarter. We have some preliminary ideas. We think that the opportunities are significant relative to the purchase price that we paid for the site, but I'd like to have a little bit more time to get our arms around that to develop the plan more fully. We do have a plan relative to network synergy with our Matamoros facility. There is some significant cash savings to consolidate the Matamoros production into Ecatepec. That is a priority that we're working on. And we'll have a better idea in terms of the timing of that over the next couple of weeks so...

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

Yes. No problem. I'll look out for that question on the next call. And then regarding the weather you said impacted some of the polyol volumes. Can you kind of give little more detail around what the weather effectively impacts?

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

So we had poor weather impact us in North America, primarily in the Northeast of the United States. And then, we also had poor weather in Europe. From a European perspective, I'm looking at a number here, trying to get a number. I would guess 10%. Yes, I would guess our European business was down probably about 10%, which was significant. And I will say, we kind of dialed in our North American polyol number pretty well. We got a little bit of a hit with the Northeast, but it was in the range of what we expected. But we were surprised by the negative impact in Europe, again, being down 10%. And again, we would attribute that to weather and potentially some lost share of PIR insulation, and again, we're still looking at that closely.

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

Got you. And that's on the demand side, I assume, where people cannot install because of the weather or...

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

Yes. Not install because of the weather. Generally, we're just getting really into the insulation season in North America and in Europe now. Generally, May, June is the startup of the intensity of the seasons.

Matthew John Eaken - *Stepan Company - VP, Corporate Controller & Interim CFO*

And David, I would comment typically that business is not lost. It's just delayed. So where they have to delay construction projects. It's not like they go away, they're just pushed back further. If you have a leaking roof, you're going to fix it. And again, typically 70% of our business tends to be replacement roofs and not new roofs.

Operator

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

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

If I could just ask for a clarification. The comment about polymers offsetting growth and demand for the remainder of the year, offsetting the market share losses. Was that a volume comment or more of a earnings comment for that business?

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

Volume.

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

That was volume. Okay. And should we anticipate that the market share headwinds is just a situation that it's -- until we lap that and which if I recall was third quarter last year that should remain an impact on until we lap that situation?

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

Yes. That's generally correct, Curt.

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

Okay. And just on the Surfactant business, you talked about some growth that you saw in the Oilfield as well as Ag. Can you talk about, what you're seeing there? Obviously, oil's been on a recovery here. Ag still would have thought maybe -- was a little more sluggish so just maybe some more color on just what kind of growth you're seeing there and what the drivers are?

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

I would say in the Oilfield, our sales generally are going to support fracking and/or they are biocides that are being sold into the production of oil today. And so the growth, again, we have a relatively small oilfield business today. But if you look at the combination of Oilfield, Ag and our Tier 2, Tier 3 business, I mentioned that the profit contributions of those businesses were up significantly. Profit contributions were up approximately 10% from those businesses. So we feel pretty good about the growth that's occurring in those markets today. And we believe that performance will be sustained for the balance of the year and hopefully expanded.

Operator

Thank you, gentleman. We have no further 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. Thank you very much for joining us on the call today. We appreciate your interest and ownership in Stepan Company. We look forward to reporting to you on our second quarter 2018 call. Have a great day. Thank you.

Operator

Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your line. Thank you and have a good day.