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Q4 2018 Innophos Holdings Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 20, 2019 / 2:00PM GMT



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PRESENTATION

Operator

Greetings, and welcome to the Innophos Fourth Quarter 2018 Earnings Conference Call. My name is Michelle, and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

I would now like to turn the call over to your host, Mark Feuerbach, Vice President of Investor Relations. Mr. Feuerbach, you may begin.

Mark Feuerbach *Innophos, Inc. - VP Investor Relations, Treasury, Financial Planning & Analysis*

Good morning, and thank you for joining us today for Innophos's Fourth Quarter and Year-End 2018 Results Conference Call. Joining me on the call today are Kim Ann Mink, Chairman, President and Chief Executive Officer; and Han Kieftenbeld, Chief Financial Officer.

Please turn to Slide 2. During the course of this call, management may make or reiterate forward-looking statements made in this morning's press release regarding financial performance and future events. We will attempt to identify these statements by use of words such as "expects," "believes," "anticipates," "intends," "estimates" and other words that denote future events. These forward-looking statements are subject to material risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements.

We caution you to consider the important risks and other factors as set forth in the Forward-Looking Statements section and in Item 1A, Risk Factors, in our annual report on Form 10-K, as filed with the SEC, that could cause actual results to differ materially from those in the forward-looking statements made in this conference call.

Also, I would like to remind you that during the course of this conference call, management will discuss non-GAAP measures in talking about the company's performance. Our adjusted EBITDA financial measure excludes stock-based compensation, currency translation, severance, value chain transition expenses, Mexico natural gas imbalance and supply adjustment charges, fair value inventory adjustments and M&A-related costs.

Please refer to our press release, the appendix of today's presentation and our SEC filings for the GAAP to non-GAAP reconciliations.

We will make a replay of this conference call available for a limited time over the telephone at the numbers set forth in the press release and via webcast available on the company website. In addition, please note that the date of this conference call is February 20, 2019, and the presentation for this call can be found on our website at www.innophos.com, in the Investor Relations Events section. Any forward-looking statements we may make today are based on assumptions that we believe to be reasonable as of this date, and we undertake no obligation to update these statements.

Please turn to Slide 3. During the call today, management will be reviewing our fourth quarter and year-end 2018 financial performance and 2019 outlook, after which we will open the call up for questions.

With that, please turn to Slide 4, as I turn the call over to Dr. Kim Ann Mink.

Kim Ann Mink *Innophos Holdings, Inc. - Chairman of the Board, President and Chief Executive Officer*

Thanks, Mark, and good morning, everyone, and thank you for joining us today. 2018 was an important transition year for Innophos as we executed against our Vision 2022 strategic road map by building the critical capabilities that will transform the growth profile of the



Company. Significant strides were made in advancing the multi-faceted strategic value chain repositioning initiative, developing innovative solutions that better serve our customers and enhance our position in attractive Food, Health and Nutrition end markets, and capitalizing on our value-selling commercial model.

On a full year basis, we grew sales by 11%, GAAP net income by 61%, and adjusted EBITDA by 4%, all consistent with our expectations going into the quarter. Now in Q4, sales of \$193 million were flat compared with the prior year, as a stabilized base business and pricing power were partially offset by lower nutrition sales resulting from our previously announced decision to discontinue a portion of low-margin nutrition trading business.

GAAP net income for the quarter was \$5 million, or \$0.24 per share, which was 143% ahead of Q4 2017, due primarily to tax reform charges in the prior year.

Q4 adjusted EBITDA of \$30 million, was up 10%, and adjusted EBITDA margin of 15%, was up 143 basis points, as higher input costs were fully offset by the benefits of selling price increases and lower operating expense. Further, by remaining disciplined with the management of our liquidity position, we reduced our debt and realized net leverage of 2.2x.

Now by taking actions to proactively manage near-term market dynamics, while advancing our key initiatives under our strategic pillars, we are entering 2019 with good momentum. Our priorities this year are to execute against these initiatives in order to pursue our Vision 2022 goals and deliver long-term value for our customers and shareholders.

Please turn to Slide 5. Now before moving onto strategic highlights, I want to note that despite the headwinds we faced throughout 2018, we achieved year-over-year revenue and EBITDA growth, and importantly, sequential stability across key metrics. Notably, 2018 revenue grew compared with 2017, as acquisitions and pricing actions in our base business more than offset operations-related issues and the discontinuation of select low-margin nutrition trading business in the second half of 2018. Adjusted EBITDA was up on a full year basis and was also sequentially consistent throughout the year.

With that, I'd like to take a closer look at some of the key achievements in 2018 under our strategic pillars, so please turn to Slide 6.

In Operational Excellence, significant progress was made throughout the year in advancing our strategic value chain repositioning initiative with the completion of major milestones. This included the signing of strategic PPA and MGA supply agreements and receipt of the negotiated \$20 million payment to offset near-term value chain specific transition charges as well as the long lead-time environmental and operational government permits. We also advanced the multi-faceted CapEx investments to increase the self-sufficiency of MGA supply from the Coatzacoalcos facility and switched the Geismar facility to the new multi-source supply structure.

The transition of the multi-faceted supply chain is expected to continue through the first half of 2019 with the benefits of the lower cost structure being captured during the latter half of the year. Now we do remain on track to deliver adjusted diluted EPS improvement of 10%, which represents an estimated annual run rate of \$0.25 to \$0.27 per share. Additionally, in Q4, we completed our Phase 2 Operational Excellence program, capturing a total of \$5 million of savings in 2018 across raw material purchases and MRO parts and labor and planning and logistics. This did fall short of the Phase 2 Operational Excellence savings target of \$9 million due to the unprecedented increases in freight market rates.

Now under Commercial Excellence, our commercial organization has continued to successfully leverage our pricing power to offset input cost increases from inflation and higher freight expenses. We've made great progress in evolving our go-to-market value-selling model. We now have cross-functional market segment teams in place that leverage our expertise across innovation, technology, marketing and sales. And this shift to a value-based selling approach has enabled Innophos to more effectively understand the market and customers we serve. This has been key in supporting our efforts to capture price increases and in driving success with new product development initiatives under the strategic growth pillar.

Now under strategic growth, we remain focused on advancing both organic and inorganic growth opportunities that strengthen Innophos' position as a value-adding, higher-margin ingredient solutions provider for high-growth FHN markets.



Now on the organic side, we do continue to deliver wins through our SPARC new product development program. These efforts leverage our acquired and legacy capabilities as well as our cross-functional commercial models. They also support our strategy to shift our portfolio mix over time to a greater level of higher-margin, higher-value, branded ingredient and formulated solutions.

So for example, during the fourth quarter, we launched a new proprietary herbal blend for a well-known global consumer health company. This new product required specialized processing to deliver specific properties that support the launch of 2 new product forms, chewable and effervescent tablets, under a well-known brand supporting immune health.

Our formulators also developed a custom blend of health-promoting minerals and vitamins for a children's chewable product launched in Asia by one of our global dietary supplement customers. And finally, supporting the demand by today's active consumers for nutrition derived from natural, plant-based sources, we launched a vegan mineral complex for a new dietary supplement for the sports nutrition market.

We also continue to actively evaluate M&A opportunities to drive inorganic growth that meet our disciplined and requisite corporate strategic and financial criteria to strengthen our FHN platform. At this stage in our transformation, our 3 strategic pillars are deeply ingrained in the Innophos culture and highly interconnected.

So looking forward to 2019, our focus is on executing on the key initiatives across our strategic pillars. And by doing so, we are positioning Innophos to deliver improved profitability and realize our Vision 2022 goals for sustainable top- and bottom line growth.

So with that, I'll now turn the call over to Han. Han?

Han Kieftenbeld *Innophos Holdings, Inc. - Senior VP & CFO*

Thank you, Kim Ann, and good morning, everyone. Please turn to Slide 7. Before I review the details of our Q4 financial performance, I would like to note key financial highlights for the quarter.

Q4 revenue of \$193 million was in line with our guidance and the prior year. Adjusted EBITDA, also in line with our guidance, was up 10% year-over-year with an adjusted EBITDA margin of 15%, reflecting base business price increases that exceeded input cost increases.

We ended the year with a strong cash position, including \$52 million of free cash flow generated in the quarter, which is triple the prior year quarter as we received the \$20 million Nutrien payment and \$23 million from the sale leaseback transaction.

Now let's turn to Slide 8 to take a closer look at the quarter details. Sales of \$193 million in the quarter were flat year-over-year as the 3% increase in the base business was offset by the discontinued portion of low-margin nutrition trading business, which we communicated in Q3. Volumes were down 7%, while average selling prices were up 7%.

On a full year basis, our sales improved by 11% versus 2017, reflecting the benefit of our acquisitions and proactive pricing programs that have offset input cost increases.

Q4 gross margin was 15%, down 147 basis points from the prior year quarter due to the impacts from the value chain transition charges, higher energy cost and the write-off of mining concessions in Mexico, an action we decided to take as the mining rights acquired in 2009 do not align with our strategy. Excluding the impact from these cost increases, Q4 gross margin would have been 19% of sales. For the full year, gross margin was impacted by the same factors.

Moving on to earnings on Slide 9. Q4 net income of \$5 million was 143% higher than the prior year due to tax reform provisions booked in the prior year quarter. Adjusted EBITDA of \$30 million was up 10% compared with last year, which included a Mexico plant maintenance outage. As shown on the adjusted EBITDA bridge, selling price increases offset lower volumes and higher input cost in Q4 and for the full year.

Moving on to Slide 10 to review our performance by segment. FHN Q4 sales of \$113 million represented 58% of total Company sales and were down 2% overall, as the 5% increase from prices was offset by an 8% decrease in volumes due largely to our decision to discontinue a portion of low-margin nutrition trading business.

On a full year basis, the FHN segment represented 60% of the year sales, an increase from 55% in 2017. FHN Q4 adjusted EBITDA margin of 15% was sequentially similar to the past 2 quarters, but 377 basis points below Q4 2017 due to continued increases in freight market rates and other input costs.

IS Q4 sales were up 1%, as the 7% selling price increase was largely offset by a 5% volume decline. The IS Q4 adjusted EBITDA margin of 15% was significantly above the same quarter last year due to improved selling prices in 2018 and a favorable comparison from the maintenance outage effects in Q4 of 2017.

Other Q4 sales were \$15 million, up 11% compared with the same period last year as higher co-product selling prices more than offset lower volumes. Other adjusted EBITDA margin of 22% was up 90 basis points from Q4 2017.

Now turning to Slide 11. In the fourth quarter, net interest expense of \$4 million was up \$1 million due to higher average debt levels, along with higher market interest rates. The underlying effective Q4 tax rate was 38%, higher-than-expected due to foreign exchange effects, which have been taken out for adjusted diluted EPS. The Q4 rate normalized for these FX effects was 30%.

Capital expenditures of \$13 million in the quarter were \$3 million higher than prior year, mostly due to the value chain repositioning and manufacturing optimization initiatives. We paid \$9 million in dividends during the quarter and maintained our annual dividend rate of \$1.92 per share.

Net debt was \$280 million in Q4, down \$1 million year-over-year as we remain disciplined with the management of our liquidity position. Our net debt-to-adjusted-EBITDA ratio was 2.2x, compared to 2.3x last year.

In December, we proactively put an interest rate swap in place, fixing LIBOR at 2.677%. This rate will be valid for 3 years on \$150 million of our debt.

Now turning to Slide 12. On a GAAP basis, earnings per share of \$0.24 was up 142% due to tax reform provisions taken in the prior year period. Q4 adjusted diluted EPS was \$0.54, up \$0.02 or 3% year-over-year, as the high EBITDA contribution was largely offset by higher adjusted tax rates of 30% in the current year versus 17% in the prior year.

Moving to Slide 13. Q4 cash from operations was \$43 million and free cash flow was \$52 million, 3x the prior year quarter, reflecting the receipt of the \$20 million Nutrien payment and \$23 million from the sale-leaseback transaction. Average working capital for the quarter and for the full year 2018 was 23% of sales.

Now turning to our revenue outlook on Slide 14. Overall market conditions and the competitive landscape in 2019 are expected to be similar to 2018. Revenues are expected to be largely in line with 2018 revenue of \$802 million and approximately equally split between H1 and H2. The underlying base business is expected to remain stable.

Positive year-over-year contributors to 2019 revenue are: selling price increases, with a particular focus on Food, Health and Nutrition; new product development wins; and, new business gains. These gains are expected to be offset by: the discontinuation of lower-margin FHN nutrition trading business in 2018; lower co-product sales in the Other segment due to efficiency improvements delivered from the strategic value chain initiative; and, indirect tariffs pressure from competition, redirecting mostly technical-grade product to international markets. We anticipate limited direct impact on our North American sales.

Now turning to our earnings outlook on Slide 15. Adjusted EBITDA is expected to grow 1% to 3% in 2019 from \$125 million in 2018, with phasing in the range of 42% to 45% in H1, and 55% to 58% in H2. Positive year-over-year contributions to 2019 earnings are expected from: selling price increases, margin contribution from business gains and new product development, and the strategic value chain

program, which is on track to realize adjusted diluted EPS improvement of 10% or \$0.25 to \$0.27 per share run rate by the end of 2019.

These gains are expected to be partly offset by: input cost increases for raw materials and freight, and higher cost related to Mexico energy supply shortages that are expected through H1 of 2019. The anticipated nonrecurring portion is expected to be adjusted for non-GAAP purposes.

From a GAAP and cash perspective, the expectation is that costs will be higher during H1. The anticipated nonrecurring portion is expected to be adjusted for non-GAAP reporting purposes such as value chain transition expenses and Mexico natural gas supply adjustment charges.

Capital investments are expected to be in line with 2018 to finalize the value chain and manufacturing optimization program that commenced in 2018. Average working capital is estimated to remain in line with 2018. The company expects its effective tax rate to operate in the 28% to 32% range.

With that, I'll turn the call back over to Kim Ann.

Kim Ann Mink *Innophos Holdings, Inc. - Chairman of the Board, President and Chief Executive Officer*

Thanks, Han. And before we open the call up for questions, please turn to Slide 16, as I highlight a few key points.

Now although we expect to face some headwinds in 2019, our base business remains stable and we are confident that we have the critical capabilities in place under our strategic pillars to deliver on our promise to generate sustainable value for shareholders, for customers and our employees.

Now in 2018, we made exceptional progress with the complex strategic value chain initiative and, as a result, we are on track to meaningfully reduce our cost basis as we move through 2019.

Through our Commercial Excellence work, we've established deep customer relationships that are supported by cross-functional go-to-market model and insights-driven value proposition, and the strong commercial foundation positions us to continue to proactively leverage our value-selling approach. We also have excellent momentum with the SPARC program, and expect to accelerate our rate of new product introductions as we move through the year.

And finally, our M&A pipeline remains active, and we are committed to pursuing further inorganic growth initiatives that shift our position over time to a value-adding, higher-margin ingredient solutions provider.

We look forward to keeping you updated as we execute on our plan and continue on the path to deliver our longer-term Vision 2022 goals.

So with that, we'll now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Larry Solow with CJS Securities.

Lawrence Solow *CJS Securities, Inc. - MD*

Could you just maybe give us, Han, maybe or, Kim Ann, just a little more color on the sales outlook? It sounds like price increases are sort of offsetting the culling activity in your base business, and then there's a little bit of stuff in the Other -- in the tolling business that's impacting you and maybe a little bit impact from tariffs? But just on the base business, Novel ingredients and the other nutritional



businesses, are they still growing sort of at that 6% to 8% rate you'd thought? And then maybe phosphates are more flat to slightly up? I know you mentioned price increases, but those seem to be more, just some reaction to the higher cost basis. So could you just give us a little more volume look in what's driving the revenue?

Han Kieftenbeld *Innophos Holdings, Inc. - Senior VP & CFO*

Yes. So, Larry, this is Han. So if we look just at the past quarter, and then I'll talk to you a little bit about the looking ahead, we obviously saw the impact, and we mentioned it in the remarks that we just made, from the low-margin nutrition. If you actually look, and you asked specifically about the acquisitions, we did see volume growth to the tune of 3%. But if you actually take out at that particular fact and that decision we made, we're closer to 6%. So actually -- so that's in line with where we expect it to be, as you mentioned the range. So that's just a little bit of a background of information. Looking ahead, obviously, from a year-over-year comps perspective, we will not have that piece of business. And you also mentioned, indeed, there was a piece in the Other segment, which is the co-product sales, due to the efficiencies that we're going to realize in our Coatzacoalcos facility that we will no longer have. So we're kind of starting off from a little lower base, if you will, that's a way to think about it. And then we're growing back, we're growing back our revenue, and that's why we said in line with 2018. But make no mistake, there was actually underlying growth in both the phosphates and the nutrition portfolio to actually get us back to that same level.

Kim Ann Mink *Innophos Holdings, Inc. - Chairman of the Board, President and Chief Executive Officer*

Right. And, Larry, if you strip all those factors out, the company would be showing growth at the top line just over 3%.

Lawrence Solow *CJS Securities, Inc. - MD*

So it seems to me that the mix of your revenue is certainly getting better, obviously, right? You're intentionally culling out some of the lower-margin stuff, which I know you did for a couple of years, and then you had stopped, and then, I guess, this is in relation to Novel and more Novel. But -- and then, obviously, some of the stuff that's also dropping off is the tolling stuff, which I imagine, at the end of the day, the bottom-line profit is not driving much of a drop. So I'm now just trying to struggle a little bit with why the EBITDA number is sort of -- is it just -- because if we look back last year, you guided for '18 was \$140 million, and we're now in '19 and we're only guiding to under \$130 million. So I'm just trying to sort of gap the two, if you will.

Han Kieftenbeld *Innophos Holdings, Inc. - Senior VP & CFO*

Yes. So if you look at this year's jump off point, so the \$125 million, we see, obviously, some margin impact from, albeit small, from the business that we talked about in terms of that being discontinued, if you take that into consideration. The other factors are obviously there is continued input cost and freight market rate increases that we factor in this outlook. The other thing that there is we talked about the Mexico energy component, that is still sizable, it was in Q4, and we see that, for now at least, based on the best information we have, we see that for the first half of 2019. Obviously, we're keen to take stock as we learn more about that. But those are factors, Larry, on the downside that we see. Now on the positive side, we see wins from NPD, so new product development. We see business gains, particularly in our nutrition portfolio to make up for some of the discontinued business. And then, thirdly, our continued focus on value selling and selling price increases, those are the 3 factors that we see to more than offset some of the downside that I just mentioned.

Kim Ann Mink *Innophos Holdings, Inc. - Chairman of the Board, President and Chief Executive Officer*

Yes. So, Larry, I would sort of summarize all that. We're really providing what we believe is the realistic view of the year, given the factors that we're aware of. And we're really focused on controlling the factors that we can control, things like NPD, things like pricing, but closely monitoring those that we can't. And those are those, if you kind of think of the three buckets that are impacting us from an earnings standpoint: the Mexico energy, the continuing increase in freight charges, and those indirect impacts from tariffs. So those -- if you think about those three buckets. So again, base business, stable. We're seeing, actually, increase, but if you take away -- when you take away the headwinds, but those headwinds are real.

Lawrence Solow *CJS Securities, Inc. - MD*

Right. No, that's fair enough. And just on the value chain initiatives, and I know your guidance you have certainly more back-end loaded. Do you start getting some of that benefit in '19? I mean, is there any way to sort of say of that \$0.20, \$0.25, you achieve x percent in '19 and the rest in '20. Is it -- it sounds like majority is in '20, but is there a piece in '19 that you'll actually realize?



Han Kieftenbeld *Innophos Holdings, Inc. - Senior VP & CFO*

Yes, there is, Larry. So, the way we're looking at it right now, and obviously, we're going through this transition, still, in the first half of '19, making sure that everything is lined up in terms of our storage, our supply chain with the new supply mix, if you will. What we expect is to see an effect, and that's what we factored in for -- in this outlook right now, is for the second half, okay? So if you look at that number and you look at the \$0.25 to \$0.27, we factored in the second half component of that. Now the one thing that we've mentioned before is always that we hold approximately 1/4 worth of inventory, so that basically means that as we get to realize those benefits, it pretty much takes an average of three months to actually go through the system, if you will, from the balance sheet into the P&L. But just to be crisp on the answer, the answer is, is that we factored in half of -- for the second half of that benefit that we've talked about.

Kim Ann Mink *Innophos Holdings, Inc. - Chairman of the Board, President and Chief Executive Officer*

And, Larry, one last item I would add is just to put it into context, it's taking the first half of the year to really optimize the new supply structure and, hence, the reason why the benefits are more back-end loaded.

Lawrence Solow *CJS Securities, Inc. - MD*

Okay, fair enough. And then just how about, lastly, I realize acquisitions are not an exact science and I imagine the queue is still very full, but just, globally, can you give us sort of an update? I know you guys have targeted sort of, I guess, almost getting EBITDA to double with the sort of rate we're at today, and that by 2022, is that maybe a little bit pushed out now or is it -- any thoughts on that?

Kim Ann Mink *Innophos Holdings, Inc. - Chairman of the Board, President and Chief Executive Officer*

Yes, no. I can start here. Our pipeline remains very active. And as we've spoken about in the past, we're looking at target acquisitions that are really going to build on the Novel, and NutraGenesis acquisitions, really strengthening that FHN platform. I can say we continue to be actively pursuing our M&A agenda and evaluating opportunities. But we are disciplined, and we will get our financial and strategic fit criteria. With regard to Vision 2022, we are on track, we remain -- we do remain on track to hit that \$1.25 billion, which, as we've discussed and as we rolled out our Vision 2022, \$475 million of that would come from M&A. So we do remain on track, that was actually -- when we put that Vision 2022 out, that was actually looking at getting our first tranche, if you will, of new acquisitions in the 2018 timeframe, and we actually bought them in 2017. So we still remain confident about that direction.

Operator

(Operator Instructions) There are no further questions at this time. I would like to turn the call back over to Ms. Mink for any closing remarks.

Kim Ann Mink *Innophos Holdings, Inc. - Chairman of the Board, President and Chief Executive Officer*

Sure. Thank you, Michelle. I want to thank everyone for joining us today, and we look forward to keeping you updated on our progress throughout 2019. Thanks again, and have a great day.

Operator

Thank you. This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation and have a wonderful day.



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