THOMSON REUTERS

EDITED TRANSCRIPT

Q3 2018 Innophos Holdings Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 01, 2018 / 1:00PM GMT

CORPORATE PARTICIPANTS

Han Kieftenbeld *Innophos Holdings, Inc. - Senior VP & CFO*
Kim Ann Mink *Innophos Holdings, Inc. - Chairman of the Board, President and Chief Executive Officer*
Mark Feuerbach *Innophos, Inc. - VP -- Investor Relations, Treasury, Financial Planning & Analysis*

CONFERENCE CALL PARTICIPANTS

Curtis Siegmeyer *KeyBanc Capital Markets Inc., Research Division - Associate*
Lawrence Solow *CJS Securities, Inc. - Managing Director*

PRESENTATION

Operator

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

I would now like to turn the conference over to your host, Mark Feuerbach. Thank you. 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' Third Quarter 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 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 disputed 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 November 1, 2018, 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 third quarter 2018 financial performance and 2018 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. Our third quarter results were in line with the preliminary expectations that we announced on October 16th. We delivered top line growth of 7% year over year as we benefited from a stabilized base portfolio, contribution from our acquisitions and our ongoing pricing actions. Our Food, Health and Nutrition, or FHN segment, demonstrated strong year-over-year growth at 17%, with 14% of the growth from acquisitions and 3% from the legacy portfolio.

Our adjusted EBITDA of $32 million came in at the top end of the previously issued range and was sequentially in line with Q1 and Q2.

Net income was $14 million. On a year-over-year basis, our Q3 results reflect higher energy and freight expenses, the benefits from SG&A cost actions and a favorable reversal to a portion of the tax reform provisions booked in Q4 2017, which Han will expand upon later.

In addition, as we indicated in our pre-release, our Q3 performance and our current outlook for 2018 reflect our revised expectations regarding a shift in the timing of the anticipated initial value chain repositioning benefits from 2018 to 2019, a portfolio decision to discontinue selective lower-margin nutrition trading business with a single customer, and the Q3 and Q4 impact from isolated operational issues in our phosphate portfolio.

Please turn to Slide 5. As demonstrated on this slide, despite these near-term headwinds, on a sequential basis the business remains sound with adjusted EBITDA and adjusted diluted earnings per share sequentially in line with Q1 and Q2 of this year.

Turning to Slide 6. Additionally, we are confident that we are taking the necessary proactive actions to manage the near-term dynamics of the business.

Notably, we swiftly acted to implement corrective measures to address the operational issues encountered in Q3. As a result, the impact will be limited to 2018, and we do not expect these issues will extend into 2019.

To benefit our free cash flow, we moved forward with a sale leaseback transaction for a non-core asset. This has long been identified as a potential strategic action, and we determined that it was an opportune time to act given market rates. Combined with the $20 million Nutrien payment that we previously announced, we expect to generate an estimated $40 million in positive cash flow in the fourth quarter of 2018 from these two transactions.

Now to streamline our cost structure, we implemented SG&A actions that delivered benefits in Q3 and are anticipated to deliver further benefits in Q4 of 2018 and carry forward into 2019. It is important to emphasize that the cost actions we took, while prudent, were focused on areas of the business that allowed for efficiency improvements and have not compromised our ability to support growth. In fact, we have continued to invest in customer support functions.

We have also simultaneously continued to execute against our key initiatives under our strategic pillars.

Please turn to Slide 7. In Operational Excellence, we continue to deliver benefits and nurture a continuous improvement culture. We also completed two important milestones to advance the completion of our multi-faceted value chain redesign. We also completed another significant step in our value chain repositioning by receiving the long lead-time environmental and operational government permits at our Geismar, Louisiana plant. These permits will allow us to diversify our raw material supply chain in Geismar, and in turn, further improve our overall supply structure starting in January 2019.

We also completed a new multi-year PPA supply agreement with Emaphos, which complements the previously announced PPA supply agreement with Nutrien and supplements our internal PPA production. As a result, we have further diversified sourcing for our phosphates portfolio and are better positioned to deliver an improved sustainable cost structure.

Now under Commercial Excellence, our commercial organization has continued to have success implementing proactive price increases to offset input cost increases from inflation and higher freight costs. The work we have done over the past three years to strengthen our customer relationships through our Commercial Excellence initiatives has proven to be very, very valuable in helping us manage customer relationships in the current inflationary environment.

Now moving on to Strategic Growth. Our strategy to transform Innophos to be a value-adding, higher-margin ingredient solutions provider is driven by our organic and inorganic growth initiatives. To strengthen our organic growth prospects, we continue to deliver wins to our SPARC new product development program that is informed by consumer benefit platforms and aligns with specialty, high-growth FHN markets. It also leverages our science and technology capabilities that were strengthened with last year's acquisitions.

And in Q3, we've launched several new products that align with benefit platforms like clean label, weight management, healthful sleep and sports performance and recovery. For example, we developed the customized plant-based Enzyme Blend that is beneficial for digestive health for a manufacturer of nutraceutical and pharmaceutical products.

In addition, working with a leading supplement provider we also developed an essential minerals complex that allows for increased vitamin C absorption to provide energy while also supporting nerve and muscle function.

Now the addition of these new products, which leverage both acquired and legacy capabilities, enhances the level of higher margin, higher-value branded ingredient and formulated solutions in Innophos' nutrition portfolio and supports our strategy to shift our portfolio mix over time.

In fact, by leveraging the skills of our broader technology organization coupled with our disciplined SPARC new product development process, we have more than tripled the number of new products launched. We also continue to selectively evaluate M&A opportunities to drive this mix shift and continue to enhance our growth profile. We remain diligent in evaluating opportunities that align with our strategic criteria of strengthening our position as an essential ingredients provider in high-growth FHN markets and meet our disciplined financial criteria.

We believe that we have the balance sheet and the foundational strength to pursue the right opportunities.

In summary, we are confident that we are effectively managing the near-term business dynamics, and that our strategic programs are positioning Innophos to deliver long-term value for our customers and our shareholders.

As a result, we are on track to deliver double-digit year-on-year revenue growth in 2018, achieve an adjusted diluted EPS improvement of 10% by the end of 2019 and accomplish our Vision 2022 goals.

Now with that, I'll turn the call over to Han.

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

Thank you, Kim Ann, and good morning, everyone. Please turn to Slide 8. Before I review the details of our financial performance, I would like to note a few highlights.

In Q3, we achieved revenue growth of $13 million or 7% compared with the prior year quarter, as we benefited from contributions from acquisitions and ongoing pricing actions that offset volume declines in our Industrial Specialties and Other segments. On a GAAP basis, Q3 net income and EPS were up versus prior year due to favorable revision to the tax reform provision, which was partially offset by isolated operational issues that impacted sales in the phosphates portfolio, as well as an unfavorable sales mix in the Industrial Specialties segment. Higher raw material, freight and energy costs also impacted Q3 earnings.

During the third quarter of 2018, our provisional tax amounts were reduced by approximately $6 million due to the reversal of a portion of the tax reform provision booked in Q4 of 2017. This resulted in a tax rate of minus 22% before adjustment in Q3 of 2018 and a favorable impact to diluted EPS of $0.30 per share.

As indicated in this morning's release, after the close of the third quarter, we received new and unprecedented charges of $2 million related to natural gas consumption in our Mexico plant. We are actively disputing these charges. Pending resolutions, we prudently booked the charge in Q3 and have adjusted these charges for non-GAAP comparative purposes.

Adjusted EBITDA was down 9% year-over-year, but as Kim Ann noted, in line sequentially with Q1 and Q2 as selling price increases helped to offset a combination of lower volumes, greater input costs and higher freight and energy expenses. Adjusted EBITDA margin was down versus prior year.

Adjusted diluted EPS was $0.58, down versus prior year due to lower volume effects caused by the isolated operational issues. Sequentially, earnings were up, as selling price increases were effective in offsetting higher input costs.

Q3 adjusted earnings reflect our typical adjustments as well as adjustments for value chain transition expenses and the disputed natural gas charges related to our Mexico operations.

Operating cash flow was $19 million and free cash flow was $5 million, down from Q3 2017 due to lower earnings and the capital expenditures and working capital needs to support the value chain repositioning and manufacturing optimization program.

Now let's turn to Slide 9 to take a closer look at the quarter details. Sales of $197 million in the quarter were up 7% due to 3% higher volumes and 4% higher average selling prices.

Growth from acquisitions was up 7%, but the growth rate was down sequentially due to lapping of the Novel acquisition and a decision to discontinue a portion of low-margin nutrition trading business. On a year-to-date basis, our sales improved by 15% versus 2017, reflecting the benefit of our acquisitions and proactive pricing programs that have offset input cost increases.

Q3 gross margin was 18%, down 440 basis points from the prior year quarter due to the increased weighting of the 2017 acquired businesses as well as the impact from the value chain transition charges.

Moving on to earnings on Slide 10. Q3 net income of $14 million were $3 million higher than the prior year due to the previously referenced tax adjustments, which more than offset the Q3 factors discussed earlier.

Adjusted EBITDA of $32 million was up sequentially but down 9% compared with last year due to the factors that I reviewed earlier. As shown on the adjusted EBITDA bridge, let me highlight that selling price increases offset higher input costs in Q3 as well as year to date.

Moving on to Slide 11 to review our performance by segment. FHN Q3 sales of $115 million represented 59% of total company sales and were up 17% overall, with 14% due to the contributions from acquisitions and an additional 3% from both price and volume growth in our legacy business.

FHN Q3 adjusted EBITDA margin of 15% was 400 basis points below 2017, due to the impact of the isolated operational issues on the phosphates portfolio and dilution effect from lower-margin acquisitions in our nutrition portfolio.

IS Q3 sales were down 3%, as selling price increases partially offset volume declines. The IS Q3 adjusted EBITDA margin of 19% was 288 basis points below the same quarter last year due to the impact of the operational issues and unfavorable sales mix.

Other Q3 sales were $16 million, down 10% compared with the same period last year due to the lower level of co-product sales.

Now turning to Slide 12. Net interest expense of $3 million in the quarter was up $2 million due to higher debt levels related to the 2017 acquisitions, along with higher interest rates. The underlying effective Q3 tax rate, excluding the previously mentioned partial reversal of tax reform provisions, was 30%.

Capital expenditures of $14 million in the quarter was up 66% from the same quarter last year due to the strategic value chain and manufacturing optimization investments.

We paid $9 million in dividends during the quarter, and our annual dividend rate of $1.92 per share was maintained.

Finally, in the third quarter, net debt was $322 million, up $60 million year-over-year, reflecting the $28 million spent on the Q4 2017 acquisition and higher working capital and CapEx for value chain investments.

Our net debt-to-adjusted EBITDA ratio was 2.6x.

Now turning to Slide 13. On a GAAP basis, earnings per share of $0.71 benefited from the favorable $0.30 impact from the tax reform provision remeasurement. Q3 adjusted diluted EPS was $0.58, down $0.20 or 25% year-over-year, primarily due to lower volume effects caused by isolated operational issues, partially offset by selling price increases.

Moving to Slide 14. Q3 cash from operations was $19 million and free cash flow was $5 million, up sequentially but down from the same period last year, due primarily to greater working capital and CapEx needs to support the value chain repositioning and manufacturing optimization initiatives. Average working capital was 22% of sales for the first 9 months of 2018, in line with the prior year.

Now turning to our outlook on Slide 15. For full year 2018, we are reiterating the revenue and adjusted EBITDA guidance provided on October 16, 2018. Revenue is expected to grow 10% to 12% compared with full-year 2017, which equates to a range of $791 million to $806 million. Adjusted EBITDA is expected to grow 3% to 7% compared with full year 2017, which equates to a range of $123 million to $128 million.

As previously indicated, we are making targeted capital investments throughout 2018 in support of our strategic value chain repositioning and manufacturing optimization program, an initiative we expect to meaningfully improve earnings, free cash flow and return on invested capital in future years. The value chain transition charges are expected to impact gap earnings during H2 2018 and H1 2019. These transition costs are incurred ahead of the $20 million negotiated payment from Nutrien accruing to earnings, as referenced earlier.

Overall market conditions and the competitive landscape are expected to be similar in Q4 compared with prior quarters with Q4 expected to reflect the usual seasonality, thus being the softest sales quarter in the year. During the first 9 months of the year, selling price increase have been effective in offsetting input cost increases. We have continued to take further price increase actions to address continued cost inflation in our operating environment.

Excluding the Q3 adjustment to the tax provision, as discussed in today's earnings release, the company anticipates the effective tax rate to operate in the 29% to 31% range.

Q4 free cash flow is expected to benefit by an estimated $40 million from two key initiatives: our previously announced intention to complete a sale leaseback transaction and the Nutrien contractual payment.

Finally, we continue to diligently work through the multi-faceted value chain repositioning and manufacturing optimization program and expect full benefits to materialize by the end of 2019, delivering adjusted diluted EPS improvement of 10%, which represents an estimated run rate of $0.25 to $0.27 per share.

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

Kim Ann Mink: Thanks, Han. Before we open the call up for questions, please turn to Slide 16, as I highlight a few key points.

Our performance this quarter was in line with our revised expectations with year-on-year top line growth and earnings sequentially in line with Q1 and Q2. We have responded swiftly to address the near-term headwinds that we faced in Q3.

We remain laser-focused on instilling a culture of continuous improvement through our Operational Excellence initiatives, leveraging our proactive pricing efforts through our Commercial Excellence initiatives to offset input costs; and advancing our organic and inorganic growth initiatives to shift our position over time to a value-adding, higher-margin ingredient solutions provider. We have continued to make great strides in advancing our multi-faceted strategic value chain repositioning and manufacturing optimization program. Despite the early savings benefits shifting into 2019, we are on track to successfully transition to our new, lower-cost value chain in 2019 and achieve our targeted 10% improvement to our adjusted diluted EPS. Again, this equates to an improved $0.25 to $0.27 per share run rate by the end of 2019.

And, we remain confident that Innophos is positioned to deliver double-digit revenue growth in 2018 and long-term sustainable growth for our shareholders.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Larry Solow from CJS Securities.

Lawrence Solow ***CJS Securities, Inc. - Managing Director***

Kim Ann, you mentioned some of the near-term challenges -- during the quarter obviously in Q3. One thing I just wanted to ask, can you maybe just help us parse out the slowdown in revenue. It seems like there are two main issues: one is sort of, your decision, your discretion to cull some of the low-margin trading activity, seems like the other one was just -- you had difficulties meeting demand because you had supply issues. I guess, the questions I have are -- have those supply issues been resolved? And then secondly, are there other things causing the slowdown? Have you seen any changes in the market at all? Or -- and if not, could we sort of expect a return to the 2% to 3% organic growth?

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

Yes, thanks, Larry. Glad you could join us. Now on the operational issues, these were isolated issues in select units of our phosphate plants, and we have actively addressed them. And we do not foresee any negative impacts from these issues affecting 2019. The demand on the phosphate side was very, very strong, and hence we could not, in fact, fulfill the orders we had. So, there were orders there but due to the operational issues, we did not have the material to fulfill it. We do not expect these operational issues to continue into 2019. Now from the nutrition side, as you said, we did decide to discontinue the portion of a lower-margin trading business with a single customer. As we progressed with 2019 negotiations related to this particular customer, we determined very late in the quarter that the margin profile of this business was no longer attractive enough to maintain that business, which, obviously, then is impacting the second half of 2018 and beyond. We do not expect -- we continue to see strong orders in the combined nutrition portfolio. Obviously, we will not have this customer going forward into 2019, but we will -- we're working very hard to offset that revenue that we decided not to continue with. But the orders are very strong, and we should continue to see in the nutrition side, as I have been saying, anywhere between that 4% to 6% market growth. I continue to feel confident for 2019 because the dynamics, the underlying dynamics continue to be very strong.

Lawrence Solow ***CJS Securities, Inc. - Managing Director***

And outside of the nutrition piece, again, I know you are not giving guidance for '19. But do you see any -- has there been any real material changes, one way or the other? Any impact from international, geopolitical tariffs, China, dollar weakness, dollar strength, again, I guess, I should say. Any of that stuff at all changing at all? Or -- I'm just trying to -- the stock, obviously, has taken a material rundown and sometimes things get a little ahead of itself. So just trying to clear out if there's anything out there that we should be concerned about?

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

No. I know, we've been talking about previously, when I first came on board as a CEO, we have the Chinese competition and so forth. We don't see that as strongly, and we continue to say that the dynamics in the marketplace for us are very, very good. The pricing power we've had, we've led with that, and we continue to get the pricing. We've more than offset our input costs. From some of the geopolitical things going on, the tariffs implemented to date are not expected to have any significant direct effects on our results. We may -- we see -- we do expect maybe some small indirect effects in other parts of the world as Chinese competitors selectively sell elsewhere instead of exporting to the U.S., but that's all considered in our guidance already. So no, we don't expect to see any major dynamics in the marketplace at this point in time, we don't foresee anything.

Operator

(Operator Instructions) And our next question is from Curtis Siegmeyer from KeyBanc Capital Markets.

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

Could you just provide a little bit more color on, you mentioned, obviously, exiting the lower-margin nutrition business but mix was a $2 million headwind in the quarter. So I would think with exiting that maybe mix would've improved, and so just wondering what drove that headwind on the mix side? And then on the manufacturing headwinds, just wondering, if that was isolated, was that all Novel-related? In your slides, you mentioned that it had to do with the acquisitions, so just trying to get a little bit more color there as well.

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

Yes. Let me take the first part of your question and then -- Curt, and then, Kim Ann will probably address the second part of your question. So, the first part of your question was around mix and what we're seeing there, that's basically in our phosphates portfolio. And if you look, last year, and you can see that from one of the slides in the deck as well as some of the supporting schedules, we had a very significant quarter in Industrial Specialties, particularly. And as a result of very high margin there, and there were some unique kind of features at the time, Q3 of 2017, which didn't repeat -- so it was really that year-over-year comparison. If you look sequentially, the business is all around in phosphates and in the baseline business very consistent, both on the top line and actually on the bottom line too, because one of the slides we had in the deck and you look at it from the sequential adjusted EBITDA performance, you see a very sequential, consistent EBITDA performance. So yes, there was last year kind of an extraordinary mix if you will on the IS side particularly, but that's kind of the main explanation there.

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

Okay. And then if I could just follow up on the input costs headwind as well. You had $8 million that you're able to offset with price. I was wondering, I guess, a couple of things on that: one, how much of that was logistics and freight versus the actual raw materials? And then, are we at a point now, does it feel that it's stabilizing going forward? Or is that continuing to rise as we kind of go into 4Q here?

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

Yes. So we think, looking ahead into Q4, our expectation is that, that it is stabilizing. As it relates to Q3 per se and kind of the year-to-date, we have and we've communicated this prior. We continue to see input cost inflation, particularly -- and you highlighted freight, particularly as it relates to freight. This is nationwide, I would say, not just industry-wide, it's nationwide that has affected us and everybody else. We've obviously continued to respond to that with the selling price increase, hence the full offset. But all of the magnitude of that $8 million increase that you've seen on the input cost side, around 25%, is related to freight.

Kim Ann Mink: I guess, I would add, Curt, just on the pricing actions. We have gone out with another price increase, October 1. So, we are very active in controlling what we can control, and we continue to be successful in gaining those pricings.

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

Right.

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

And do you sense your customers are pretty understanding when you put these pricing increases through? Or are we at a point, maybe, where there could be some impact on demand if competitors aren't following suit?

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

We have been successful so far, and we have led the pack and there are competitors that are following.

Operator

This concludes the question-and-answer session. I'd like to turn the floor back to Dr. Kim Ann Mink for her closing comments.

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

Thank You, Matt, and thank you all for joining us today. We look forward to keeping you updated on our progress.

Operator

This concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.