Sensient Technologies Corporation

Q2 2020 Earnings Conference Call

Friday, July 17, 2020, 09:30 A.M. Eastern

CORPORATE PARTICIPANTS

Steve Rolfs – *Senior Vice President and Chief Financial Officer*

Paul Manning – *Chairman, President and Chief Executive Officer*

PRESENTATION

Operator
Good morning, and welcome to the Sensient Technologies Corporation 2020 Second Quarter Earnings Conference Call. All participants will be in a listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key, followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then one on your telephone keypad. To withdraw your question, please press star, then two. Please also note that today's event is being recorded.

I would now like to turn the conference over to Mr. Steve Rolfs. Please go ahead, sir.

Steve Rolfs
Good morning. I'm Steve Rolfs, Senior Vice President and Chief Financial Officer of Sensient Technologies Corporation. I would like to welcome all of you to Sensient's conference call to discuss 2020 second quarter financial results. I'm joined this morning by Paul Manning, Sensient's Chairman, President and Chief Executive Officer.

This morning, we released our 2020 second quarter financial results. A copy of the release and our investor presentation is now available on our website at sensient.com.

During our call today, we will reference certain non-GAAP financial measures, which we believe provide investors with additional information to evaluate the company's performance and improve the comparability of results between reporting periods. These non-GAAP financial results should not be considered in isolation from or as a substitute for financial information calculated in accordance with GAAP.

A reconciliation of non-GAAP financial measures to the most directly comparable GAAP financial measure is available on the Investor Information section of our website at sensient.com and in our press release. We encourage investors to review these reconciliations in connection with the comments we make this morning.

I would also like to remind everyone that comments made this morning, including responses to your questions, may include forward-looking statements. Our actual results may differ materially, particularly in view of the uncertainties created by the COVID-19 pandemic, governmental attempts at remedial action and the timing of a return of more normal economic activity.

We urge you to read Sensient's filings, including our 10-K, our first quarter 10-Q and our forthcoming second quarter 10-Q for a description of additional factors that could potentially impact our financial results. Please bear these factors in mind when you analyze our comments today.

Now we will hear from Paul Manning.

Paul Manning
Thank you, Steve. Good morning. Sensient reported second quarter earnings this morning. I'm very pleased with the results of our Flavors and Fragrances Group as well as our food and beverage business in the Color Group.

Flavors and Fragrances is up mid-single digits in revenue and high single digits in operating profit during the quarter, continuing its revenue growth trend from the first quarter. We also had

favorable growth in our natural colors and pharmaceutical businesses, which were up in the quarter. The growth in these businesses is offset by the adverse impact of COVID-19 in the personal care market and throughout Latin America, Europe and Asia Pacific. Despite these COVID-19 headwinds and based on current trends, we expect to deliver on our EPS outlook for the year.

I'm also pleased on the progress we have made during the quarter on our divestitures. We completed the sale of our Inks business and signed a definitive agreement to sell our yogurt fruit prep business. We anticipate closing the yogurt fruit prep sale in the third quarter. We continue to make progress on that divestiture of our aroma chemical and fragrance compound business. Although we have been delayed by COVID-19, we believe we can close this transaction by the end of the year.

All of our production facilities are open and have been throughout the pandemic. Our on-time delivery remains high and we have successfully managed our raw materials. Our staffing and attendance at our facilities remains outstanding, and I'm very proud of the dedication of our employees. We will continue to closely monitor each of our production facilities to remain ahead of prevailing GMP and sanitation practices.

As a result of COVID-19, we have incurred additional costs and we have experienced significant revenue headwinds in a number of businesses. Overall, the impact of COVID-19 has reduced our EPS by approximately $0.10 year-to-date. The impact of COVID-19 on our food and beverage business is mixed. However, the impact is significantly negative for our personal care business.

Now let me turn to the groups. The Flavor Group had another nice quarter. Adjusted local currency revenue for the group was up 5.7%. The group continues to experience positive sales growth in the finished flavors and extract product lines, as well as an improving picture in the flavor ingredient product lines. The natural ingredients business also had a solid quarter. The overall impact of COVID-19 was negative to the group's revenue.

The group's revenue growth is based on strong new wins generated throughout 2019 and the first part of 2020, retaining existing business and an overall decline in attrition, which was a lingering effect from our earlier restructuring activities. Net of these factors, we have generated mid-single-digit growth year-to-date and I anticipate the same growth rate for the remainder of the year.

This quarter, the flavor group returned to quarterly profit growth with adjusted local currency operating profit up 8%. The higher profit was a direct result of the higher volumes, new wins and the group's production cost initiatives. Moving forward, I anticipate continued profit growth. Overall, the group's operating profit margin was up 30 basis points in the quarter, and I would anticipate a 50 to 100 basis point improvement for the year.

In summary, I expect mid-single-digit revenue growth and mid to high single-digit operating profit growth for the flavor group for the remainder of the year. Within our color group, revenue for food and beverage colors was up low single digits for the quarter. Pharmaceutical had a nice quarter, up double digits and natural colors continues to grow and that product line is up mid-single digits for the year.

Similar to the Flavor Group, Colors continues to focus on retaining existing business and improving the group's overall sales win rate. Unfortunately, the growth in Food and Beverage Colors revenue was offset by a more than 20% decline in our personal care business revenue.

While we saw some improvement in our personal care business in Asia and Latin America, the demand for makeup in Europe and North America was down substantially in the quarter.

Given the uncertainty with COVID-19 and continued restrictions, I would anticipate continuing challenges for this product line in the second half of the year.

In terms of operating profit, the color group achieved mid-single-digit profit growth in Food and Beverage Colors for the quarter and has generated double-digit operating profit growth for the year. However, profit in personal care in the quarter was down by more than 35% due to the lower demand in makeup and other personal care products and that was the main reason for the Color Group's overall decline in profit.

The Color Group remains focused on production takeout actions. However, these actions need more time to realize their full potential and we do not expect that the actions will outpace the profit decline in Personal Care. Short of a significant opening of the world economy, I would expect the profit declines in the Personal Care business to continue for the remainder of the year.

In summary, Food and Beverage Colors revenue is up nearly mid-single digits year-to-date and double digits for profit. For the back half of the year, I would expect mid-single-digit revenue growth and mid to high single-digit profit growth for that product line. Because of the impact of Personal Care, we would expect the Color Group to be flat in revenue and profit for the year.

Our Asia Pacific Group had solid revenue growth in some regions, but this growth was offset by declines in other regions as government COVID-19 restrictions have significantly impacted many sales channels. The Group delivered outstanding profit growth in the quarter, and I anticipate the Group to return to revenue growth once restrictions in certain areas begin to ease.

Based upon current trends, I expect Asia to deliver low single-digit sales growth and mid to high single-digit profit growth for the year. Overall, for the company, we continue to focus on our supply chain. We have increased our inventory levels on certain key raw materials and as a result, we are providing outstanding on-time delivery to our customers around the world.

While we do experience supply chain disruptions, we have avoided any significant financial disruptions and we continue to reduce our overall inventory levels for the company. I'm pleased with the progress we've made in the first six months of this year. The Flavor Group has had a great first half, and I would anticipate this to continue in the second half.

Our Food and Beverage Colors business is also performing well. In Asia Pacific, I'm confident that the strategy and investment we have in place will return this Group to revenue growth. While I'm optimistic about our Food businesses, our Personal Care business will continue to struggle. Furthermore, the ultimate impact of COVID-19 remains unknowable.

New product launches are significantly below prior year, and there has been some customer SKU rationalizations. Nevertheless, our business is strong and well positioned to grow for the year.

Steve will now provide you with additional details on the second quarter results.

Steve Rolfs
Thank you, Paul. In my comments this morning, I'll be explaining the differences between our GAAP results and our adjusted results. The adjusted results for 2020 and 2019 remove the impact of the divestiture related costs and the operations divested, or to be divested. The second

quarter 2019 results do not include any divestiture related costs. We believe that the removal of the gains and losses connected to the businesses that we are divesting provides a clearer picture to investors of the company's performance. This also reflects how management reviews the company's operations and performance.

Included in this year's second quarter reported results is a gain realized related to the reclassification of accumulated foreign currency translation as a result of the sale of the Inks business, as well as other divestiture related costs, which were primarily non-cash. These items, which are included in the divestiture and other related costs, increased net earnings by $1 million or approximately $0.02 per share.

In addition, this year's second quarter reported results include $28.2 million of revenue and an immaterial amount of operating income related to the results of the operations to be divested. Last year's second quarter results include $36.4 million of revenue and an immaterial amount of operating income from the operations to be divested.

Excluding divestiture related costs and the results of operations to be divested, consolidated adjusted revenue was $294.9 million in the second quarter of 2020 compared to $302.8 million in the second quarter of 2019. Consolidated adjusted operating income was $40.3 million in the second quarter of 2020, compared to $47 million in the second quarter of 2019.

Adjusted diluted earnings per share was $0.70 in this year's second quarter compared to $0.81 in last year's second quarter. We have reduced debt by approximately $60 million since the beginning of the year and approximately $120 million over the last 12 months. We have adequate liquidity to meet operating and financial needs through our cash flow and available credit lines.

Our debt to EBITDA is now just under 2.7. Cash flow from operations was $107.6 million for the first six months of 2020, an increase of 41%. Capital expenditures were $21.4 million in the first six months of 2020, compared to $16.6 million in the first six months of 2019. We expect our capital expenditures to be approximately $50 million for the year.

Our free cash flow increased approximately 45% during the first six months of 2020 to $86.2 million. We expect continued strong cash flow growth for the remainder of the year. Consistent with what we communicated during our last call, we expect our adjusted consolidated operating income and earnings maybe flat to lower in 2020, because of the level of non-cash performance-based equity that may be deducted in 2020 based on our results.

We also expected a higher tax rate in 2020 compared to our 2019 rate, which was lower as a result of a number of planning opportunities. Based on current trends, the company is increasing our GAAP earnings per share guidance to $2.10 to $2.35. This guidance now includes $0.35 to $0.40 per share of divestiture and other related costs and the results of the operations to be divested. This guidance also includes approximately $0.10 of currency headwinds based on current exchange rates.

On an adjusted basis, based on current trends, we are maintaining our original estimate for the year of a range of $2.60 to $2.80, which excludes divestiture related costs, the impact of the divested, or to be divested businesses, and foreign currency impacts. We are also maintaining our adjusted EBITDA guidance of low to mid-single-digit growth. Please see our press release for a simple summary table of this EPS guidance.

Thank you for your time this morning. We will now open the call for questions.

QUESTIONS AND ANSWERS

Operator
Thank you. We will now begin the question-and-answer session. To ask a question, you may press star, then one on your touchtone phone. To withdraw your question, please press star, then two. At this time, we will pause momentarily to assemble our roster. Our first question today will come from Heidi Vesterinen with Exane. Please go ahead.

Heidi Vesterinen
Hi. Good morning. Paul, I think you said in your opening comments that COVID was a net negative for Flavors. Could you elaborate on what you meant if I heard that correctly? Because I thought you may have benefited from pantry loading, a lot of your peers are talking about that and then as a related question, to finish on Flavors, some of your peers have talked about pressure in food service, did you see that as well and how big is your exposure to this area? That's my first two questions. Thanks.

Paul Manning
Okay. Well, good morning, Heidi, or good afternoon actually. On the COVID being a net negative for Flavors, let's take the revenue portion. While there were certain segments that were up, for example, process foods, soups, things of that nature, there were a number of segments that were also down, ice cream, confectionary, beverage. That's from a product line standpoint. From a sales channel standpoint, indeed QSR, in many of our regions was a big headwind and in particular that played out not necessarily exclusively in Flavors. We saw that in Asia Pacific and we saw that in Colors as well. The traditional retail outlet food stores and the like, we did not have that type of headwind. From a geographical standpoint, as COVID has evolved that that has impacted countries at different timeframes. Right now, we're in the thick of things in Latin America, certainly, we had those geographic headwinds towards the end of Q2, and of course those continue into Q3. Europe, we had an improving situation and I would tell you that in the U.S. we had an improving situation, but you take all those things together, and that's what we would say from a revenue standpoint, it was a net negative. Now, as that flows down to profit, there's that contribution, but then of course, we also have the incremental costs associated with cleaning and PPE and everything from air freights or rush shipments, all these other logistical and supply chain costs that certainly also were a headwind. There was obviously a lot less travel, but the net of all those factors for the Flavor Group, I would tell you, overall was negative, but certainly there were pieces that it was favorable, but there were plenty of pieces where it was not favorable.

Heidi Vesterinen
Thank you and then, separately, there's a view out there and some peers have talked about this, that smaller customers are challenged. You have historically said that you work a lot with the so-called B and C customers. Have you seen any smaller customers being challenged? There's a general view that, larger multinationals are winning. What's your view there?

Paul Manning
My view is, it's fairly mixed. In some locales, multinationals have reduced, shrunk SKU's for sure. There are other multinationals that are strongly aligned with certain channels, like QSR that are not performing particularly well. On the other hand, there are some smaller local brands that are quite essential to the market that they're serving and I would tell you that in both cases, there is an overall reduction in terms of the number of product launches that is for sure for our business, whether that's smaller B and C types or big A types, but in terms of activity, I would have to tell you that overall, in my opinion as I look at the whole company, we probably see more activity from

a product development and what can we develop now, and what are we going to develop coming out of this pandemic, we see more of that activity on the B and C level than we do on the A level. I would tell you that here again, in my opinion, we see a lot more activity customers, employees returning. We see more of that activity at some of these B and Cs than we do at a number of the As.

Heidi Vesterinen
Thank you.

Paul Manning
Okay. Sure thing.

Operator
The next question will come from Mark Connelly with Stephens. Please go ahead.

Mark Connelly
Thank you. I wonder if we could follow up on that just a little bit, in terms of what kind of product development. Have you started to see a shift in where your customers are putting their priorities? We've come to the conclusion that gluten-free is dead now that everybody is baking bread, I'm curious whether you're seeing your customers shift more towards the food as medicine side, or whether that it's just a greater pace of activity across the board?

Paul Manning
Yes, that's a great question, because when I talk about pantry loading and a lot of that is processed food or food that tends to have a longer shelf life that does not lend itself to the natural nutraceutical profile that we all heard about quite a bit coming into COVID, which tends to have much shorter shelf lives. I would tell you that most of the product activity, or let me say it this way, there's a lot more functional and nutraceutical attributes that customers are looking for. For example, our pharmaceutical business did quite well. We're selling a lot of functional ingredients there, which can go into pharmaceutical over-the-counter applications and probably more likely nutraceutical applications, we see a lot of activity there.

On the Personal Care side, we talk about makeup, certainly there's a big headwind there, but there's this other category out there somewhat akin to the nutraceutical market, which is described oftentimes as cosmeceuticals. These would be cosmetic products that bear some type of functional benefit to either the skin or to the hair or some other attribute that people are trying to enhance. There is more of that activity. In fact, at some customers that has accelerated well beyond any activity that we saw even before COVID-19. I tend to think that with so much of the development slowed and in some cases almost completely stopped at some customers, you're right about this notion that products containing certain gluten-free or other, some would say is, before the pandemic, we certainly see a slowdown in that activity. Coming into 2021 and 2022, it'll be very interesting to see how the market responds, how quickly the customer's resume that priority towards fresher, healthier, more natural products and how much continued emphasis there'll be on the more, say historical or in some cases even legacy products at some of our customers. That one, I couldn't tell you yet, but I can tell you for a fact, lot of activity on the nutraceutical functional aspect of our products that would go into pharma, food and even personal care.

Mark Connelly
It's helpful. Just two more things. First, with the administration basically saying Phase 2 is no longer a priority or at least no longer a near-term priority, does that cause you to shift any of your

Asia Pacific priorities? I know China is not a big market, but I'm curious whether China is causing you more competition over there now?

Paul Manning
Well, I would say this, every country has a different approach being taken by governments and in fact, as everybody is well aware, even within a single country, there may be multiple, local governments, coming up with their own programs, and this just plays out in different places and in different ways and on different timelines and our approach to that has been, we are an essential business. We are going to continue to operate. If customers want to develop new products, we are very happy to do that, our labs are open. If customers want to continue to have their existing products, we can do that too and our on-time delivery is absolutely outstanding, and we can continue to fulfill those particular needs, but I think our business model and that of the folks in this space of ingredients, if we want to call it that, they tend to have a model you produce locally for your local customers and your local markets. For example, we produce in China for China. I'm not aware of many, if any products that we export from China to the U.S or to any other jurisdiction and I think that model will continue to us and actually that's been quite helpful through this, because we don't have to necessarily jump through a lot of logistical hurdles in many cases when we're sourcing manufacturing, product support, supply chain support locally to those local customers.

Mark Connelly
Okay and just one last question. Working capital was quite a bit better than we expected and better than what I'm seeing elsewhere. Is there anything we should be thinking about for the second half?

Steve Rolfs
That's been an initiative that we've been focusing on for the last year and a half, we're really trying to exercise very tight control over our inventories, as well as our receivables and payables and over the last 12 months, we've done well on inventory. I will say actually in the quarter, consistent with Paul's comments, we urged some of our businesses to stock up on certain raw materials. We made some investments in inventory, but we did well on receivables. Our receivables days have come down about a day and I think you're also just seeing a better mix of cash earnings out of the business this year, and that's helping contribute to cash flow.

Paul Manning
But I would also say this, we certainly have more work to do on reducing our inventory levels throughout the company. We've taken many, many days out, not only on the trailing 12 months, but even on the trailing 6 months and we've got a lot of supply chain initiatives that probably have a lot less to do with specifically serving customers, but they have a lot more to do with generating internal cash and improving efficiencies. There's a lot more of that to underway. I would anticipate we have inventory reductions, well into the rest of the year and into next year and that could be something to anticipate for everybody.

Mark Connelly
Very nice to see in this environment. Thank you.

Operator
Once again as a reminder, if you would like to ask a question, please press star, then one. The next question comes from Mitra Ramgopal with Sidoti. Please go ahead.

Mitra Ramgopal

Yes. Hello and good morning. Thanks for taking the questions. First, I just wanted to be sure I heard this right. I think, Paul, you mentioned that I think COVID has had about a $0.10 impact on EPS for the half. Just wanted to double check if that's a net number or just from the headwinds you've been seeing, because I know you've also benefited a little from it?

Steve Rolfs
Sure. Mitra, that is a net number. We looked at the sales impact, which Paul spoke to. We looked at the one-time costs and then we've also fortunately had some offsetting savings in the area of travel. When you net all that together, that was $0.10 year-to-date. I think there may have been a little bit of positive impact in Q1 and a little bit of a greater negative impact in Q2, but year-to-date net of $0.10.

Mitra Ramgopal
Okay. No, thanks. That's great and on the divestiture front, you're obviously making nice progress as it relates to the sales. I was just curious -- a couple of questions on that. First, the use of the proceeds, if that's going to be primarily for reducing debt and as you've gone through this process and given COVID, I was wondering if this has changed anything as it relates to your longer-term growth strategy, as you look at the remaining businesses and areas you probably would like to be more active in?

Paul Manning
The proceeds from those divestitures will go towards reducing debt. As you've seen, we've taken out a whole bunch of debt over the last 12 months, over the last 6 months. Our debt to EBITDA is now just below 2.7, it's actually 2.68, if I could quote you precisely, the number I like to watch very carefully. That's what we're going to continue to focus on for sure. Hey, we always look at other uses of our cash as well, but I think for the here and now, that that's how we're going to play that one. With respect to the strategy of the business, we have been underway with our diversification program in cosmetics for some time. In other words, how can we utilize some of our technologies more directly into the skin care market, into other personal care applications that just for example, oral care, have a very good hair care and hair coloring business, but there's certainly more opportunities for us in that segment as well. If anything -- COVID-19 is accelerating our penetration in these other segments, have a very good product line that in many cases is very suitable for those areas. There's a lot of customers in that space throughout Americas, Asia and in Europe. We feel very good about that it is still a very good and growing market. It's a strong technology-based market and I think we can be quite successful there. Beyond that though, we're going to just keep rodding and roping in Colors and Flavors. We've got a very strong focus on what we want to do and I think we're starting to show the world that we can be successful with this strategy and now I feel good about where that's going for the rest of the year and into 2021, for sure.

Mitra Ramgopal
Okay. No, that's great and a little of a follow-up on that. On COVID, I'm just wondering how you view the environment as it relates to on a competitive front and an update in terms of what you're seeing on the raw material and being able to implement some favorable pricing for you?

Paul Manning
Well, let me take that first part first. Raw materials, this is something that I think we got well ahead of this whole situation earlier in this year and we loaded up thoughtfully on a number of our strategic raw materials that perhaps had more sensitivity than, say more mundane raw materials. We had a very strong effort there, but along with that, you can have raw materials all day long, but if your employees aren't producing and you're not delivering these things and managing the

supply chain around them, that's only half the battle, and, yes, our folks have just been unbelievable putting these -- not only from the supply chain, but from the production and the quality and the lab support across the board, it's been a real team effort and I think we've seen some very impressive results there, I like our chances moving forward as well on the supply chain. We're going to continue to watch it, whether there's another lockdown or not a lockdown, as I said, we just assume pretty much the worst in all cases and that tends to be a good policy for us when you consider -- because it's all about delivering and it's delivering on-time to our customers. In fact, our delivery is better in June than it was before the pandemic, our people are very engaged, and they understand their mission and they're very motivated to complete it. Now with respect to competition, we deal with different folks in different parts of the world and in a lot of different product lines and we're happy to know when they're not doing well, because we'd like to take advantage of that fact and service the customers and, that's all I had to say about that piece.

Mitra Ramgopal
Okay. No, that's great and then finally, Steve, I just was curious in terms of, where there could be some leverage in the model and I know it's on the selling and admin side, the first half or second quarter pretty similar to what we saw in the first quarter. I was just curious how should we think about the back half given the ongoing divestitures?

Steve Rolfs
Yes. I think any increase that you saw in SG&A in the quarter, was going to be attributable to primarily incentive accruals. We're actually watching SG&A very closely and getting some benefits from the reduced travel that we see right now. With this type of volume growth, particularly in Flavors, we should continue to see good operating leverage. We've spent a number of years rationalizing our production footprint. We have SG&A capable of supporting significant growth without having to make new investments. With revenue growth, we should be able to generate good operating leverage.

Mitra Ramgopal
Okay. Thanks again for taking the questions.

Paul Manning
Okay. Thanks, Mitra.

Operator
At this time, there are no further questions. I would now like to turn the conference back to the company for any closing remarks.

CONCLUSION

Steve Rolfs
Okay. Thank you everyone for your time this morning. That will conclude our call. Goodbye and have a good day. Thank you.

Operator
Thank you. The conference has now concluded. You may now disconnect your lines.