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IFF - Q3 2017 International Flavors & Fragrances Inc Earnings Call

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PRESENTATION

Operator

At this time, I would like to welcome everyone to the International Flavors & Fragrances Third Quarter 2017 Earnings Conference Call. (Operator Instructions) I would now like to turn -- introduce Michael DeVeau, Head of Investor Relations. You may begin.

Michael DeVeau - *International Flavors & Fragrances Inc. - VP of Global Corporate Communications & IR*

Thank you. Good morning, good afternoon and good evening, everyone. Welcome to IFF's Third Quarter 2017 Conference Call. Yesterday evening, we distributed a press release announcing our financial results. A copy of the release can be found on our IR website at ir.iff.com. Please note that this call is being recorded live and will be available for replay on our website.

Please take a moment to review our forward-looking statements. During the call, we'll be making forward-looking statements about the company's performance, particularly with regard to our outlook for the fourth quarter and full year 2017. These statements are based on how we see things today and contain elements of uncertainty. For additional information concerning the factors that can cause actual results to differ materially from forward-looking statements, please refer to our cautionary statement and risk factors contained in our 10-K filed on February 28, 2017, and our press release that we filed yesterday.

Today's presentation will include non-GAAP financial measures, which exclude those that we believe affect comparability. A reconciliation of these non-GAAP financial measures to their respective GAAP measures is set forth in our press release that we issued yesterday.



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With me on the call is our Chairman and CEO, Andreas Fibig; and our Executive Vice President and CFO, Rich O'Leary. We will start with prepared remarks, and then take any questions that you may have.

With that, I would now like to introduce Andreas.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Thank you, Mike. As usually, I would like to start with an executive overview of our financial performance for the third quarter. Then I want to provide some key highlights of our strategic progression. Once finished, I will ask Rich to cover our financial results in greater detail, including specifics on each business unit as well as our cash flow statement and outlook for the remainder of the year.

We are pleased with our third quarter results as we achieved growth across all categories and regions. Currency-neutral sales grew 12% on a consolidated basis, with an equal contribution from Flavors and Fragrances. Both business units delivered market improvements versus the first half, moving from a low single-digit organic performance to mid-single-digit organic growth in quarter 3, led by strong new win performance as well as improved volume trends on existing business. Our top line also continues to benefit from our recent acquisitions, contributing approximately 6 percentage points of growth in the quarter. At the same time, our focus on driving greater efficiencies throughout our business via cost and productivity initiatives continue to support overall profitability as currency-neutral adjusted operating profit grew 7% this quarter. Rich will take you through the drivers of year-over-year profit performance. Currency-neutral adjusted EPS increased 5% due primarily by operating profit growth, a low effective tax rate and a year-over-year reduction in shares outstanding, which more than offset high interest expense related to dual carrying cost on our recent \$500 million bond as well as existing private placements, which were due in September. Fully recognizing that we have continued to operate in a challenging global environment, we are pleased with our financial performance through September 2017. Our team continues to deliver winning innovative solutions to our customers while achieving sustained profitable growth for our shareholders. On a year-to-year basis, currency-neutral sales growth for the first 9 months was strong at 9% versus 11% growth in Flavors and 7% growth in Fragrances. Adjusted operating profit grew 5% and adjusted EPS increased 8%, both on currency-neutral basis.

I wanted to take a few minutes to highlight a few of our strategic accomplishments in the third quarter. In terms of innovating firsts in Flavors, sales of our Sweetness and Savory Modulation portfolio continued its strength of strong double-digit currency-neutral growth across all categories, led by Savory and Dairy. On the Fragrance side, encapsulation-related sales grew high single digits, led primarily by Fabric Care and Personal Wash. Tastepoint, our new brand within IFF designed to serve the dynamic and faster-growing middle-market customers in North America, improved strong double digits in the third quarter. This early success shows that our efforts have been very well received by our middle-market customers, and that combining the long-established and well-regarded relationships of Ottens Flavors and David Michael is the right approach to serve these critically important growth accounts. Lucas Meyer Cosmetics, acquired now 2 years ago, remains a primary growth driver as cosmetic active ingredients continued its strong growth, improving double digits in the third quarter.

We also opened a fully renovated and expanded facility in Cairo, Egypt. These investments support both our regional focus on growth in the Middle East and Africa as well as our focus on key categories, providing enhanced services to customers and strengthening our presence in the key market. The expanded labs will allow us to better serve our Egyptian customers and strengthen our market presence in Africa and the Middle East, and that remains a critical component of our long-term strategy. I should note that in the third quarter, our Middle East, Africa region improved high single digits.

I'm also happy to announce that we recently launched our Re-Imagine... programs in Flavors to accelerate innovation and increase agility to capture unmet opportunities in the changing food and beverage market.

Based on a combination of future trends, analysis, consumer insight and a modernized cross-category development process, the programs guide our research and development efforts to ensure an innovation pipeline that addresses the evolving consumer needs and desires. It is another way in which we show how we are dedicated to being our customers' partner of choice as we progress our business strategy, embed sustainable thinking throughout the creation process and continue to strengthen our industry-leading innovation platforms.



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The programs focus on 6 key areas including culinary, citrus, delivery systems, naturals, modulation and protein and were selected based on market potential, customer input, export, industry collaboration and versatility across end-use categories. They consider rapidly changing world on the expectation of sophisticated consumers too busy to cook for themselves to the realities of a warming climate and its impact on key crops and ingredients to an increased awareness of our role in the health of the planet. This extensive innovation platform requires an innovative approach to taste creation. To address this, our bespoke IFF Taste Design is a combination of artisanal handcrafted techniques and proprietary technologies that drive consumer preference and market differentiation. We believe that both our Re-Imagine... programs and our IFF Taste Design approach will provide our customers with winning taste and further establish us as their essential partner.

In terms of sustainability, I'm pleased to announce that we have joined FReSH, a project of the World Business Council on Sustainable Development designed to improve the health of people and the planet by recalibrating the global system of consumption, transportation, production and agriculture, thus achieving the initiative's goal to make responsibly, produce healthy, enjoyable diets available for all. As a standing member of the WBCSD, IFF will join forces with the EAT Foundation and 25 leading businesses and science companies to accelerate transformational change in global food systems. We are passionate about doing the right thing and happy to have the opportunity and contribute in areas where we can make a positive difference in the world.

With that, I would like to turn the call over to Rich.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Thank you, Andreas. Before reviewing our results by business unit, I'd like to start by walking you through the drivers of currency-neutral adjusted operating profit growth. On this slide, we show you the year-over-year impact in terms of contribution of growth, expressed as a percentage of our restated third quarter 2016 adjusted operating profit.

Starting with the second bar, you can see that volume represented 15 percentage points of operating profit growth. In the third bar, the net contribution of acquisitions added 5 percentage points of operating profit growth. And please note that this also includes both operating performance and synergies. We also continue to benefit from our cost and productivity initiatives through the likes of formula optimization, procurement savings, plus the restructuring program savings, we've delivered approximately 4 percentage points of benefit year-over-year. If we combine all cost and productivity programs into one bucket, including both organic and inorganic components, it would represent approximately 7 percentage points expressed as a percentage of sale -- of operating profit.

From a headwind perspective, as seen in the next bar, sales mix had a negative impact as we experienced stronger share of sales growth in Savory, specifically snacks, Fabric Care and Fragrance Ingredients, which have lower-than-average margin profiles. In the sixth bar, price to input cost was unfavorable by about 4 percentage points as favorability in Flavors was offset by Fragrance. This reflects target adjustments with select customers as well as strategic price reductions within Fragrance Ingredients.

In the next bar, we have highlighted RSA expenses, which represented a 9 percentage point headwind. Please note that included in the bar is incentive compensation, where we have a large year-over-year variance and represents approximately 2/3 of the change.

Regarding incentive compensation, we are highly incentivized to deliver on our financial commitments. There are variations in incentive compensation as it is based on our performance relative to our annual plan. If we achieve our financial targets, we'll receive 100% of our designated payout. Should we over or underperform versus plan, our incentive compensation is adjusted higher or lower. In terms of the year-over-year comparison in the third quarter, we have large delta as we are comparing to a lower base period due to underperformance in the prior year quarter versus strong results in the current year quarter. For simplicity purpose, we have grouped several miscellaneous items into Other as they are negligible.

Turning to the business unit reviews for the third quarter. Flavors currency-neutral sales increased 12% with a strong contribution related to the acquisition of David Michael and, to a much lesser extent, PowderPure as well as mid-single-digit organic growth where all categories, led by Savory, improved year-over-year driven by new wins.



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From a regional perspective, all 4 regions delivered growth, led by strong double-digit performance in North America, which improved 28%, reflecting additional sales related to acquisitions, principally David Michael, as well as high single-digit growth on an organic basis driven by new win performance in Savory and Beverage. EAME increased 12% on a currency-neutral basis, inclusive of additional sales related to the acquisition of David Michael, with the strongest growth in Beverage and Dairy.

On a geographic basis, Western, Central and Southeast Europe as well as Africa and Middle East all reported strong growth. Greater Asia grew 2% on a currency-neutral basis in the third quarter, driven principally by double-digit growth in India and a high single-digit growth in Thailand. Latin America increased 1% on a currency-neutral basis as growth in Colombia and Argentina more than offset softness in Brazil. In the third quarter, we experienced isolated pressure with a limited number of customers who are experiencing challenges on a volumetric basis.

On a currency-neutral segment profit basis, Flavors grew approximately 19%, led by volume growth with contribution of acquisitions and the benefit from productivity initiatives. Overall, price versus input cost was slightly favorable in the quarter.

The situation regarding raw materials, such as vanilla and citrus, remains fluid and volatility, and we continue to pursue price increases where appropriate.

In terms of currency-neutral segment profit margin, we achieved margin expansion year-over-year of approximately 130 basis points to 22.3%.

Fragrance currency-neutral sales improved 12% as overall growth was broad based, with a balanced contribution between organic and acquired businesses. Regionally, growth was strongest in EAME and Latin America, increasing double digits, followed by mid-single-digit growth in Greater Asia.

From a category perspective, Fine Fragrance improved 18% on a currency-neutral basis, including Fragrance Resources. Organically, performance was driven by strong new wins in EAME, Greater Asia and North America as well as improved volume trends in Latin America. Some of those new launches included YSL Y, Armani Because It's You by L'Oréal, At the Beach by Limited Brands and Pure XS by Puig. Consumer Fragrances grew 11% on a currency-neutral basis, with a balanced contribution from organic business and additional sales related to the acquisition of Fragrance Resources. Organically, nearly all categories achieved growth, led by strong double-digit growth in Home Care and high single-digit growth in Fabric Care, driven primarily by wins. I'd like to note that Consumer Fragrance has showed a marked improvement relative to second quarter of 2017, growing 6% year-over-year as the volume on existing business was positive in Q3.

Fragrance Ingredients sales were up 8% on a currency-neutral basis, primarily driven by double-digit growth in EAME and Latin America. IFF | Lucas Meyer's Cosmetics also continued to perform well as it grew double digits in the third quarter.

From a profit perspective, Fragrance currency-neutral segment profit increased 6% on a currency-neutral basis as volume growth, the contribution of acquisitions and the benefits from productivity initiatives more than offset unfavorable price to input costs, weaker sales mix and higher incentive compensation expense. We do expect to see input costs rising as we exit 2017, and as such, have already initiated discussions with the customers regarding the need for price recovery in 2018. In terms of currency-neutral segment profit margin, our profile remains strong at 20.2%.

Moving on to cash flow. Operating cash flow was \$199 million year-to-date, which compares the \$342 million in the first 9 months of 2016. Performance was adversely impacted primarily by the previously announced ZoomEssence litigation settlement, which was about \$56 million and higher working capital requirements, in particular accounts receivable. It should be noted that we expect accounts receivable to improve going forward, partly due to timing regarding stronger sales in Q3, with collections in Q4 and as well as traction on our improvement program.

From a capital allocation standpoint, we spent approximately \$77 million on capital expenditures or about 3% of sales, and we believe we will spend approximately 4% to 4.5% of sales in 2017.

Regarding cash returned to shareholders. Through the first 9 months, we've spent approximately \$150 million -- \$152 million on dividends and \$53 million on share repurchases. Last week, our Board of Directors approved an extension of our existing share repurchase authorization through 2022, with a total value of \$300 million, including approximately \$50 million remaining on our prior authorization. This share repurchase authorization



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is consistent with our established return on capital strategy and reinforces our belief that IFF is well positioned for the future. Our strong financial position and cash generation enables us to return cash to our shareholders as we continue to strategically invest both organically and through acquisitions to create long-term value for our shareholders.

Based on our year-to-date performance, in our outlook for the fourth quarter, we remain optimistic that we can achieve our previously stated currency-neutral guidance for the full year 2017. We are reiterating our currency-neutral sales growth projection of 7.5% to 8.5%, with the expectation that we could be at the higher end of that range. We expect high single-digit growth across both business units, with broad-based contributions from acquisitions and organic performance. From an adjusted operating profit and EPS perspective, excluding the impact of currency, we expect to achieve 5.5% to 6.5% and 6.5% to 7.5%, respectively. While our currency-neutral guidance has not changed, the effect of currency movements on our results has moved. From a top line perspective, the impact of currency improved approximately 100 basis points, essentially having no impact for the full year, primarily driven by an improvement in the euro to U.S. dollar exchange rate. On a profit and an EPS basis, we anticipate a 50 basis point improvement versus last quarter. And on a full year basis, we expect that the impact of foreign exchange on adjusted operating profit to be approximately 1% and approximately 2 percentage points on adjusted EPS.

With that, I'd like to turn the call back over to Andreas.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Thank you, Rich. In summary, we are very pleased with the strong financial performance we achieved in the third quarter. We continue to be focused on the execution of our long-term strategy, accelerating growth, increasing differentiation and driving cost efficiencies to drive sustainable, profitable growth in the future and maximize value creation for our shareholders. And as Rich has stated, we are on track to deliver our previously stated 2017 financial goals on a currency-neutral basis.

With that, I would now like to open up the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Mark Astrachan with Stifel.

Mark S. Astrachan - *Stifel, Nicolaus & Company, Incorporated, Research Division - Director*

I wanted to ask -- but wanted to ask about the top line expectations for the year, so that implies fourth quarter with pretty nice acceleration on a tough comparison. I guess, how to figure out exactly how to think about what's improving in the business, what gives you visibly that you're going to be able to see that improvement given those comparisons. Maybe you could talk a bit about category and what sort of had surprised you, obviously, with a strong third quarter number as you head into year-end. And I know it's sort of preliminarily, but how you think about that heading into the first half of next year as well when you have more favorable comparisons.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Okay, Mark. Let me take it. So if we look into the fourth quarter, we had a strong start into the fourth quarter up to the end of October, so that's a good thing. What we see is that our performance, in particular in Fragrance, is pretty, pretty strong. And it's continuing -- has a good -- very, very good momentum. On 2018, I prefer not to comment right now. You know we do this usually in February because, first of all, we have to close our fourth quarter, but the start was pretty good. Rich, any...



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Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. A couple things from my perspective, Mark. I mean, I think we did expect to see improvements in the second half of the year versus the first half of the year. I think we've got good strong win performance in both businesses, particularly Fine Fragrance in that category. I think we saw -- you heard in our commentary regarding the third quarter, there's a strong volume component in terms of -- on existing business. Some of that, we believe, is event driven and potentially timing. So that -- the impact between Q2, Q3, Q4 is still a bit volatile. But I think we still -- we feel -- again, as Andreas said, looking at the start of the quarter, we definitely feel like it's -- the trend, I don't think it's going to be the same level as Q3 but certainly an improvement versus what we saw in the first half of the year.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Yes.

Mark S. Astrachan - *Stifel, Nicolaus & Company, Incorporated, Research Division - Director*

Got it. That's helpful. And just on gross margin. Wanted to try to understand the puts and takes there and specifically try to figure out the puts and takes between mix and price concessions or pricing that you're giving customers and maybe help us -- sort of explain exactly what is going on there. And I guess, just lastly, how do you think about that going forward? I mean, I guess, just fourth quarter, if you don't want to talk about '18, but what the puts and takes there would be helpful.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Sure. I mean, I think on the first standpoint -- I mean, let me take mix as a starting point. As I said in the comments, I think it's -- mix is driven by our customers, and what they order is what we're going to deliver. And I think we sort of -- as I said, really strong growth, double-digit -- strong double-digit growth in Savory, particularly snacks in the Flavors business. That has below-average margins from an overall standpoint. Fragrance Ingredients, similar story, good growth, high single digits, below-average margins. And Fabric Care, good growth. So I think that's clearly the drivers of mix. I think that -- we're going to still see mix headwinds in Q4. The second component of that price to input cost, really -- I would say, 2 different dynamics going on there. On the Flavors side, as I said in my commentary, overall price to input cost was flat to slightly favorable. And we've been able to recover and pass through the increases that we're seeing in the naturals and -- that we've talked about previously, like citrus and vanilla. On the Fragrance side, we've got Fragrance Ingredients. We've talked about the strategic pricing changes we made late last year to rebalance and drive growth in that business by making modest changes in there. That -- the impact related to that has been fairly stable. Where we're seeing the greatest amount of pressure is on the compounds side. We've got customer -- large customers that has significant improvement objectives of their own. We're working -- we have to work with them and balance their short-term objectives and -- but do it in a way that provides us long-term growth opportunities. We're not going to jeopardize the entire business. On top of that, we're starting to see an acceleration of input cost in the second half of this year. Input costs were up slightly in Q2 year-over-year for the Fragrance business. That accelerated in Q3, and that's why we've talked about the need to drive and realize price realization going forward for the Fragrance business.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Yes.

Mark S. Astrachan - *Stifel, Nicolaus & Company, Incorporated, Research Division - Director*

Could you just quantify the impact in gross margin between mix and price concessions?



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Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

I would say mix on gross margin was probably 60 basis points more or less and about 80 basis points for price and input cost.

Operator

Your next question comes from the line of Katie Grafstein with Barclays.

Katie Sarah Grafstein - *Barclays PLC, Research Division - Assistant VP*

So I just wanted to ask a question on the emerging markets growth. 7% growth is the highest level, I think, since 2015. Do you see this as a sustainable inflection point? And I guess, how much of the acceleration is about true market growth and an improvement in consumer demand or optimism from customers ahead of real consumer acceleration? And then just if you could also discuss the improvement in the context of both local, regionals and multinationals, that would also be helpful.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Sure, Katie. I mean, I think it's still quite volatile. I think that as I talked about -- I mean, I think that we've seen -- on the last call and then we talked about it in today's call that I think we've seen improvements in Latin America on the Fragrance side, improvements in Brazil. We've got some of our -- one of our largest customers, a local regional customer has had a strong turnaround in their business in Brazil and Latin America in the third quarter. We feel good about that, but I would not say that we're sort of out of the woods. We saw strength in, I think, Middle East, Africa, Eastern Europe, certainly for Flavors continues to be a positive and a bright spot. I think that on the Fragrance side, Indonesia and India had strong growth in the quarter. We're still -- there's still uncertainty and challenges in Indonesia and China for the Flavors business. So it's -- I'd just say it's better. I'm not sure I'm ready to say it's an inflection point. But again, there's -- a big piece of what we saw in both businesses in Q3 versus Q2, in particular, was the volume component on existing business was much better in Q3 versus Q2.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Yes. On the local and regional customers, that's certainly a source of growth for us and a growth engine within the company not just in emerging markets, but in particular in North America in the Flavors division with the setup of Tastepoint. We have installed -- we believe that this business model fully can help us to grow the business substantially, and it's showing in the numbers so far.

Katie Sarah Grafstein - *Barclays PLC, Research Division - Assistant VP*

And then, I guess, also just talking about the acceleration in the developed markets. It's interesting just as the customers are talking about slower market conditions. So was wondering if maybe you can talk about that disconnect.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Yes. What we see is, in particular in Western Europe but also in North America, a good performance on both sides of the business. It's certainly driven by good win performance, in particular with the bigger ones. But as I said and reflected, the customer mix plays a super important role here. And with our setup, in particular in North America, that positions us very well for good growth rates and further growth to come.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

I think the other thing for me, as I mentioned a couple of times, is the volume component is definitely stronger this quarter than 5-year long-term trends. So I think some of this may be event driven, whether it's timing between Q2 into Q3 as our customers adjust their order patterns, as they



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look at what's going on in their market. So I think there's -- it's a combination of factors. I mean, we feel good about the win performance. The volume component is hard to predict from quarter-to-quarter.

Operator

Your next question comes from Heidi Vesterinen with Exane BNP Paribas.

Heidi Maria Vesterinen - *Exane BNP Paribas, Research Division - Financial Analyst*

I wanted to ask a bit more about the Re-Imagine... initiative you talked about. Could you maybe help us understand, maybe one example of what the initiative is? Is it kind of like an integrated solution? And is what you're proposing here -- what is the margin profile here compared to the rest of the group, please?

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Let me try to answer that in a way. It's actually a creative process to build our solutions, and it tries actually to look what the customers and consumers really need from the consumer insight perspective, figure out what are the most important trends and then come up with solutions, which bring as many of our technologies together as we can to make sure that we are well positioned vis-à-vis our competition, certainly, but also to satisfy the customer need and that we basically focus our investments in R&D and applied R&D on the right areas, like -- an example, like naturals, protein, delivery systems. Talking about the margins, usually the margins should be very good because we combine a lot of technologies together to come up with these solutions.

Operator

The next question comes from Mike Sison with KeyBanc.

Michael Joseph Sison - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

I think you noted cosmetic actives, another really strong quarter. Can you maybe talk about the momentum there? And are there other potential acquisitions to continue to build onto this business?

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Mike, let me take it. First of all, what we see is that this part of the market has a nice growth also compared to the core F&F markets. So that's number one. Number two, in the segment where we play with Lucas Meyer, we are in the upper premium segment, which is usually more dynamic than the other segments of the market. And now it's going into the natural actives as well, where we are, in particular, strong. Because remember, with Lucas Meyer, we have access to Southern Cross Botanicals in Australia. We have access certainly to our own naturals palette and naturals ingredients here as well. So that's going actually very, very well, and we had a good start into the fourth quarter as well. So we foresee good growth for this business going forward. And as you were asking, we always evaluate other opportunities, whether we can strengthen this business in an organic way as well.

Michael Joseph Sison - *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

Okay, great. And then encapsulations, another one that continue to post pretty good growth there. Is it still just in the laundry side that you're seeing the growth? Or are you able to -- or have you been able to move into other markets that may be could continue to grow into next year?

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Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Yes. We move now -- actually, the expansion goes in different direction. The first one is that we are evolving our encapsulation technology, which is now more multi-cap systems, which help us in the classic Fabric Care area. But we are moving technology into other categories, like Hair Care, for example, as well. And that's ongoing and in full swing.

Operator

Your next question comes from Gunther Zechmann with Bernstein.

Gunther Zechmann - *Sanford C. Bernstein & Co., LLC., Research Division - Research Analyst*

The question relates to (inaudible) cost, just following up from that. What was the pricing effect on your top line in the quarter? And given the recent trends and increases we're seeing in petrochemical in the media, do you feel an increased urge to push up prices, especially in the Fragrance division going into next year?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

In pricing itself, if you segregate it from the input cost piece, it was slightly favorable. I mean, it's less than 1 percentage point on a combined basis. As I said, I think we are seeing the start -- what we believe, the start of input cost increases on the fragrance side, and we're going to definitely have to work with the customers and get price increases to compensate for the input cost trend going forward.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Yes, which we have done actually very well this year on the Flavors side.

Gunther Zechmann - *Sanford C. Bernstein & Co., LLC., Research Division - Research Analyst*

And if I can just follow up. When are you going to lap the price rebates in the Fragrance Ingredients space?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

End of the year will be -- we'll lap it in the fourth quarter.

Operator

Your next question comes from Faiza Alwy with Deutsche Bank.

Faiza Alwy - *Deutsche Bank AG, Research Division - Research Analyst*

So a couple of questions. Can you just talk about what you're seeing from your multinational customers? So it seems like local, regional customers, the performance of those customers was better. But are you seeing an improvement from the multinational customers at all?



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Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. Look, I think that if you look at the Q3 itself, I mean, the growth was pretty well balanced between local and regional and global customers. I think the drivers of that might be slightly different, as I talked about. I mean, I think the local and regionals continue to execute well and gain share. On the global side, I think there is some element, again, of volume -- the volume swings from quarter-to-quarter, so in recovery in volumes on base business.

Faiza Alwy - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. And then just drilling in on some of the comments you made around event driven and sort of timing factors. Is that something that you saw globally? Or was it more concentrated in a particular region or category?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

I think -- let's see, I mean, it was fairly broad based. I think it was largest in North America for Fragrances, a little bit in Latin America and in Western Europe.

Faiza Alwy - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. Okay. And then just broadly, are you seeing any appetite for innovation from your customers across the board? Or do you feel like many are still just focused on whether it's short-term seasonal trends or sort of a quick pick-up from a new flavor? Or are you seeing sort of any sustained drive for innovation from your customers?

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Yes. I would say, we do and, in particular, with really cutting-edge innovation, if you talk about delivery systems or some specifics. So that's what we see, and that's actually very good. And we try to drive this trend as well with our customers.

Faiza Alwy - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. So is this -- Andreas, is this like a change that you saw this quarter? Or is this something that you've been seeing all year?

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Actually, already for quite some time. It's not specific to the quarter, I would say.

Faiza Alwy - *Deutsche Bank AG, Research Division - Research Analyst*

Okay. Okay. Okay. And then just last question for me. Rich, can you just -- I know you don't want to talk about 2018 at this point, but any guidance on FX would be really helpful in terms of the top line and the bottom line impact that you anticipate.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Let me think about this. I mean, I...



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Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

I think you should have a crystal ball on FX. So...

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes, I wish. I would be on a beach somewhere probably.

Faiza Alwy - *Deutsche Bank AG, Research Division - Research Analyst*

Assume cost rates -- assume current cost rates.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

No. Look, I mean, again, if you think about -- if we stay where we are today, we're going to have a favorable impact from a currency standpoint in the first half of next year and probably more, I'd say, flat, mute-ish in the second half of this year.

Operator

Your next question comes from Jeff Zekauskas with JPMorgan.

Silke Kueck-Valdes - *JP Morgan Chase & Co, Research Division - VP*

It's Silke Kueck for Jeff. My first question is, in the quarter, you had 6% organic currency growth and I think the profit improvement, that was 15% as you show on your slides. And the acquisitions contributed 6% of sales growth, but the profits -- the profit contribution was 5%. And maybe if you strip out synergies, maybe it contributed 2%. So the question is why is that? And what type of contribution do you expect for 2018 from the acquisitions as you try to pull out cost synergies and you integrate these businesses?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. So a couple of things, let me start with the organic business on the volume impacts. So then you've got the mix impact going as an offset to that, you've got price input cost offsetting that and then the -- particularly, the incentive comp reset are all offsets that ends up bringing that number down. On the M&A side, keep in mind that we have the amortization expense that we have to get through all of our synergy programs before we start getting the incremental leverage. The sales come right away, but we've got to work through our integration plans. We've got to work through the cost-savings programs before we start to get acceleration from an operating profit standpoint.

Silke Kueck-Valdes - *JP Morgan Chase & Co, Research Division - VP*

So that means like next year, likely the cost amortization is still that -- these are -- even the contribution next year, it may not be...

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. Once we start lapping the amortization and we are able to -- and we begin -- continue the process next year on realizing the synergies and we get the growth and that we'll get the balance of those, we'll start to get acceleration from an M&A contribution standpoint.



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Silke Kueck-Valdes - *JP Morgan Chase & Co, Research Division - VP*

What's the incremental amortization on the acquisitions year-over-year?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

\$3.6 million.

Silke Kueck-Valdes - *JP Morgan Chase & Co, Research Division - VP*

Okay. My second question is what is behind the accounts receivable issue? Why are the receivables so high? Is it a regional issue where these sales took place? Or is it just that you -- you had most of your sales at the very end of the third quarter?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

I mean, it's a huge increase in sales. We go from 2% organic growth to 6% organic growth. I mean, it's -- the biggest piece of it is just purely the volume effect in the quarter compared to where we were. If you compare December last year to third quarter this year, we had an acceleration in our business. If you compare December of '15 to third quarter '16, you had a slowing -- a deceleration of the business. So you have a different dynamic going on. I fully expect that we're going to recover that from a timing standpoint, and we'll collect those receivables in the fourth quarter. And then fourth quarter is seasonally a slower quarter. So we'll be able to recover a large portion of that outflow.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

But Rich is already collecting.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

It is a focal point. Believe me, it's a focal point for us.

Silke Kueck-Valdes - *JP Morgan Chase & Co, Research Division - VP*

Right. Like the reason why I asked this is that like an improvement in sales year-over-year in the second quarter as well and the receivable increase was implied. But sure, that's like a large -- there's a large sales increase.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes, there's a big difference in the performance.

Silke Kueck-Valdes - *JP Morgan Chase & Co, Research Division - VP*

I have 2 more questions. One has to do with Fabric Care. Is the growth in Fabric Care, does that have to do with new product launches? Or is it the case that products that was previously launched are now reaching better penetration? You're selling more of that and maybe that goes to the detriment of like what you can charge and price because you said it's sort of like a lower-margin contribution.



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Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

It's a big volume component in this number for existing business.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

So I mean, the win rates are fairly -- there hasn't been any -- they're good, but there's not been any significant uptick. It's driven primarily by the volumes on existing business.

Silke Kueck-Valdes - *JP Morgan Chase & Co, Research Division - VP*

Yes. I understand. And lastly, can you call out the acquisition a little bit more specifically? Can you discuss what the contribution was of the -- what organic sales was like for North American Flavor, excluding David Michael and what it was for the European Flavors excluding David Michael? And maybe you can do the same then for North American Fragrances and European Fragrances if you strip out the Fragrant Resource acquisition, if you had that data.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. I mean, North American Flavors on an organic basis was 7%. North America organic for total Fragrances was down 3%. What other areas would you...

Silke Kueck-Valdes - *JP Morgan Chase & Co, Research Division - VP*

And then Europe, I think there was an acquisition piece in European Flavors and also European Fragrances. So I was wondering what the organic [difference] was.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. Okay, no problem. No problem. Organic in Flavors was 10% and organic in Fragrances was 11%.

Operator

Your next question comes from Adam Samuelson with Goldman Sachs.

Adam L. Samuelson - *Goldman Sachs Group Inc., Research Division - Lead Analyst*

A lot of grounds have been covered, but maybe just a question on operating leverage in the quarter. The volume growth, I mean, very healthy, sounded like a little bit above 5%. And I'm just trying to think about if we can sustain those kind of operating profit levels into 2018 and you don't have the lap -- or the comp issue for incentive compensation this year versus last, should the implied operating leverage that you did in the quarter, ex the incentive comp, should we think about that being sustainable into the first half of next year when -- especially when your organic revenue comps are not particularly challenging?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. I mean, I'll sort of skip over the comment about not particularly challenging. But I mean, look, I mean, I think as we head into next year, certainly, incentive comp will be a significantly less headwind than what we experienced in 2017. I think that we're going to continue to drive the productivity

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agenda that we've laid out at the beginning of this year. We've got to continue execute against that. We've got to continue to look at investing and driving innovation that's going to help from a sales mix standpoint and a product mix standpoint. And we'll continue to look at our cost base and say how can we drive leverage through the P&L. It's a tough environment. It's volatile. As I talked about earlier, we've got -- we're expecting input costs to go up next year, so our ability to pass those increases on to our customers, particularly in the Fragrance side, is going to be critical to our success in 2018.

Adam L. Samuelson - *Goldman Sachs Group Inc., Research Division - Lead Analyst*

Okay. And then just a question specifically on Fine Fragrance, which did seem to improve in the third quarter. I think you alluded to some new customer wins in the prepared remarks. But any comments there on the sustainability, what you're seeing at the department store level, if you're seeing better buying activity and better expectations for foot traffic and just thoughts there. It's an important business in the Fragrance division.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Yes. So Adam, what we see is actually, on the Fine Fragrance side, a tremendous development in Europe. It's going, going very well, in particular for many of the other premium brands. So we see good demand and we certainly have a good win rate here as well. So far, we see that this hopefully will be sustainable for the months to come.

Adam L. Samuelson - *Goldman Sachs Group Inc., Research Division - Lead Analyst*

And then in the U.S., are you seeing better activity at the retail level? Or is it more Europe that's driving the strength?

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

No, it's more Europe, what's driving it at this part.

Operator

Your next question comes from John Roberts with UBS.

John Ezekiel E. Roberts - *UBS Investment Bank, Research Division - Executive Director and Equity Research Analyst, Chemicals*

I think you said you had positive price rise in Flavors. I would assume it was negative in -- but now negative in citrus. What would be the kind of offsetting categories where the overall would be positive?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Well, no, I mean, we were able to get price increases related to those materials and get out ahead of it. And then the Fragrance -- the Flavor business has done a great job in doing that. So I mean, it was slightly positive, but it's really our ability to push on -- push through and anticipate those impacts.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Yes.



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John Ezekiel E. Roberts - *UBS Investment Bank, Research Division - Executive Director and Equity Research Analyst, Chemicals*

And then it's pretty hard to time acquisitions, but would you say you're ahead of plan or behind plan or on plan in terms of the number and size of acquisitions that you've done over the past 1.5 years, 2 years?

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

We're absolutely on plan. And we are a little ahead of plan with the performance of our acquisitions compared to our business cases. So we're very happy with all the 5 acquisitions we have done in the last 2 -- 2.5 years. We are pretty much on plan.

Operator

Your next question comes from Patrick Lambert with Raymond James.

Patrick Gerard Jean Lambert - *Raymond James Euro Equities - Research Analyst*

A few questions. First, on the M&A 2018 component of the growth, sorry, for the -- for jumping for next year. But if I'm -- in our model, we have about 2% contribution from M&A for 2018. Would like to get your views on that and if nothing else is being acquired, of course. And also, what's your view on operating income impact from M&A in 2018, again, looking at the synergies, looking at the integration of acquisition, question number one. Maybe I'll let you answer that one first.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Sure, Patrick. I think from an M&A impact in '18 on acquisitions, it's really -- it's principally related to PowderPure. I mean, the Fragrance Resources was a week -- a couple of weeks, so it's not -- it's insignificant. So the 2% number that you're looking at seems way too high for me. So I think that, that impact -- again, it's only going to be -- PowderPure is really for 0.5 year is the primary impact. Again, from a profitability standpoint, all the other acquisitions go into organic, and they'll be in our guidance for the full year from an organic standpoint. We'll embed our guidance for PowderPure in the full year guidance also. But I think from a purely financial standpoint, it's what I said earlier, which is I would expect that we would -- once we lap the amortization impacts, that we'll continue to drive expansion through the synergies, growth of the business and driving improvements in the product mix of those businesses.

Patrick Gerard Jean Lambert - *Raymond James Euro Equities - Research Analyst*

Great. And second question, CapEx. Are you still targeting 4% to 5% for this year and next year? Any plans we need to consider for next year in terms of increasing capacity?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. I think we've -- for this year, I expect us to be somewhere between 4% and 4.5%. We do expect that CapEx next year will be closer to plus or minus 5% because we've still got some of the projects -- big projects in Asia that we've got to execute against. We've got China, we've got the India and some of those projects. So '18 and '19 are going to be elevated -- the elevated years.



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Patrick Gerard Jean Lambert - *Raymond James Euro Equities - Research Analyst*

Okay. And last question, I guess, the China in particular. Could you comment a bit more in details of what you're seeing in China in particular in both Flavors and Fragrances? Still weak organic development there, so if you can comment on that.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. I think it's still challenged. I mean, I think on the Flavors side, I mentioned in my comments that volume was down. We're going through and still working our way back up from some of the issues we've had. On the Fragrance side, we're seeing customers, again, trade down and not buying some of the categories where we're stronger at. We have larger exposures to some of the globals and China also, and they're struggling in the marketplace on their volume basis compared to some of the local and regional. So it's still -- I would -- it's still challenged for both business units.

Operator

Your next question comes from Brett Hundley with Vertical Group.

Brandon Groeger

This is Brandon Groeger on for Brett Hundley. Perhaps you could give us some more detail on the new Chinese Fragrance plant. Does that plant replace any existing production? Or is it additive? And when do you expect that to come online?

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

So it will come online probably end of next year and will be an addition to the existing Flavors plant we are having there. Because what we had is -- 2 years, in 2015, we had an issue with our Flavors plant. And it is probably prudent to have a second opportunity here for us on the Flavors side as well. So it will be an additional plant for...

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. There's actually 2 plants that we're dealing with. One was a smaller ingredient plant that we're finishing now and start up in the fourth quarter.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Which is on the Fragrance side.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Which is on the Fragrance Ingredients side. And then as you've seen in the footnotes to the 10-Q, we're in negotiations with the government regarding their request for us to relocate our other larger ingredient plant in China. And that, I would expect, to happen over the next 2 to 3 years.

Brandon Groeger

So relocating that other plant is an addition to this plant as well?



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Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Yes. So in both cases, they've asked us to leave the existing sites and go to a new site. And we're going to put both -- both of the plants in a single site over the next 2 years.

Brandon Groeger

Okay. And then shifting to the balance sheet. It looks like it's in a good place. You're less than 2x net levered. You recently announced the share repurchase. Ingredient valuations have been rebounding in recent months. I was thinking about your grid that dictates the repurchase of the shares. Do you intend to update that at all? And then outside of that share repurchase activity, how are you thinking about putting the balance sheet to work?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

So let me take the share repurchase first. We did -- as I noted, we did get an updated authorization from the board. It is -- the matrix is stock price driven. But I would say that there is a component of the new authorization that provides for a minimum amount of share repurchases in order -- that's targeted to offset dilution. And then on top of that will depend upon where we are versus the share price grid. From a utilization of the rest of the capacity in the balance sheet, I think, as Andreas talked about, we continue to look and pursue our M&A agenda, but it all depends upon what's available. We want to maintain -- make sure we're targeting the right deals and have the right -- the proper return profiles.

Operator

Your next question comes from Jonathan Feeney with Consumer Edge Research.

Jonathan Patrick Feeney - *Consumer Edge Research, LLC - Senior Analyst*

I wanted to talk about active cosmetics. I'm trying to look at -- a couple of regions where you saw some real big lift in the Fragrance Ingredients. Is that -- is active cosmetics growing in every region and not just 2 places where there's an offset? So if you could kind of comment on that and maybe dimensionalize how big that business could be going forward?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Jon, the big drivers in terms of where ingredients are growing significantly, which is EAME and Latin America, is on our Fragrance Ingredients side. The growth on the cosmetic active side has been pretty consistent. It's in the double digit range. So that's not driving the changes. What you're seeing is on our Ingredients business.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

And it's pretty, pretty well distributed, the growth on the active cosmetics side. Region-wise, we are certainly stronger in Europe and North America in terms of the size of the business. We still have ways to go in Asia and in Latin America, but that's good. It gives us growth opportunities going forward.

Jonathan Patrick Feeney - *Consumer Edge Research, LLC - Senior Analyst*

And just one follow-up, if I could. Rich, you -- when you -- I went back and looked at your '06, '07, like strong periods of Asia, basically global luxury fragrance development. That would advantage a Fine Fragrance business like yours. Certainly, we're seeing that across some of your key end customers. What's -- you're seeing much better growth this time around than '05, '06, '07, when you saw similar kinds of trends in beauty, particularly



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in Asia, but luxury globally. Could you comment on like why -- how much of that -- do you worry that some of that is economically cyclical? And how -- why the difference this time? What kind of capabilities do you have now around Fine Fragrance particularly that you maybe didn't have back then?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - CFO and EVP*

Look, I think it's -- there's a lot there in your question. But I mean, I think that certainly, we're seeing good growth in some of the emerging markets, Middle East, Africa in particular. But within the EAME region, as we've been talking about for several quarters, we've got -- we need to and we have a job to adapt our strategy on Fine to focus on those categories that -- in the channels that are most attractive. Certainly, that profile has changed over the last 12 to 18 months where there's a lot less going through the department stores and the brick-and-mortar. And we're going to continue to target our resources towards those, the premium and prestige components of the Fine business. Look, it's a reflection of the team we have around the world and their ability to leverage the consumer insights, understand what's going on in the market, understand our customers and designing fragrances that are attractive to the consumer. And that's ultimately what it comes down to, is our ability to put the right fragrance in the right place at the right time.

Operator

There are no further questions at this time. I'll now turn the call back over to Andreas for closing remarks.

Andreas Fibig - *International Flavors & Fragrances Inc. - Chairman and CEO*

Yes. Thank you very much for your participation, and have a good day and a good night. Thank you. Bye-bye.

Operator

Thank you for participating in today's conference. You may now disconnect.

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