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PRESENTATION

Operator

At this time, I would like to welcome everyone to the International Flavors & Fragrances Second Quarter 2018 Earnings Conference Call. (Operator Instructions) I would now like to 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 Second Quarter 2018 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 regards to the outlook for the third quarter and full year 2018. 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 22, 2018, and our press release that we filed yesterday. Today's presentation will include non-GAAP financial measures, which excludes those items 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 and is available on our website. I would like to also remind everyone that all statements related to future results and events, including the proposed merger, are forward-looking statements and are based on current expectations. Actual results and events could differ materially from those discussed here. Please refer to the information on the disclaimer slides as well as -- or the additional information contained in the regulatory filings for both companies. With me on the call today 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 & CEO*

Thank you, Mike. On the call today, our plan is to review our financial results for the second quarter in the first half of 2018, provide an update on our financial expectations for the full year, excluding the impact of Frutarom; and give insights into the strong progress related to the Frutarom transaction, then we will be happy to take any questions that you may have as usual. Starting with the recap of our first half 2018 performance. Growth was strong across all of our key financial metrics, and in line with the objectives we set out for ourselves earlier this year. Currency-neutral sales increased 6% in the first half, with most business units growing 6%, respectively. New win performance, volume growth on existing business and price increases to offset rising material costs all contributed to consolidated growth. From a profitability perspective, currency-neutral adjusted operating profit grew 5% as volume improvements and our focus to drive greater efficiencies throughout our business by our cost and productivity initiatives continue to support overall profitability. Currency-neutral adjusted EPS improved 10%, driven by improvements in adjusted operating profit as well as a more favorable effective tax rate. I'm very pleased to also report that we are making strong progress against our 4 refresh strategic priorities: solidifying a position to drive the modulation; sales of our Sweetness and Savory modulation portfolio continued to grow strong double digits across all categories, led by Savory and Dairy. PowderPure, our platform for clean label solution, grew an impressive triple digits as we continue to scale this unique and differentiated technology. Performance with local and regional customers also remained strong, growing double that of our global customers and is a trend that we see across both business units. In Flavors, specifically our midsized go-to-market platform, Tastepoint, continues to deliver strong results improving strong double digits in the first half of 2018. In terms of maximizing our portfolio, driving growth in our most margin-accretive categories, cosmetics active ingredients continues its robust growth trends by improving very strong double digits and Hair Care, Home Care, Toiletries improved high single digits. In Flavors, growth was strong in Dairy and Beverage, improving double digits and high single-digits, respectively. We also remain diligent in our focus to drive greater efficiencies in our business, allowing us to reallocate resources to efforts that drive the greatest returns. This yielded strong results in the first half 2018 as our cost of productivity initiatives, including 0 based budgeting, added approximately 5 percentage points of growth to currency-neutral adjusted operating profit and EPS growth. All in all, we believe our priorities are well positioned and our strategies to drive long-term value for our shareholders. Our pending transactions with Frutarom, which I will touch on in more detail shortly, will support and accelerate efforts across all of these pillars. With that, I would like to turn the call over to Rich.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Thanks, Andreas. Moving on to our Q2 performance. Currency-neutral sales in the second quarter grew 5%. Growth was broad-based as all regions and categories across Flavors and Fragrances posted solid results. From a profitably standpoint, currency-neutral adjusted operating profit declined 2% in the second quarter as top line growth and the benefits associated with costs and productivity initiatives were more than offset by the impact of higher raw material costs, including the previously announced BASF citral supply issue. Pricing was up about 1.5 percentage points in the quarter on a consolidated basis. However, as expected, it did not offset raw material pressure in our fragrance business unit. As we move through the back half of the year, we expect the price of raw material cost dynamic to improve as pricing takes hold in Fragrances. We are pleased that despite these challenges, we are able to achieve 8% currency-neutral adjusted EPS growth as we benefited from a more favorable year-over-year effective tax rate and a higher other income. Looking at our business unit performance for the second quarter. Flavors currency-neutral sales increased 6%, with growth coming in all categories and all regions. It should be noted that on a 2-year average basis, growth was very strong, at approximately 9%. North American Flavors improved 9% in the second quarter, led by high single-digit growth at Tastepoint and strong new wins in Beverage, Dairy and Sweet. EAME increased 5% on a currency-neutral basis, led by strong double-digit growth in Africa and the Middle East as well as mid-single digit growth in Europe. Greater Asia grew 2% in the second quarter on a currency-neutral basis as strong double-digit growth in China and India was largely offset by softness in Indonesia and Thailand. Latin America increased 8% on a currency-neutral basis, led by strong double-digit growth in Argentina and Mexico. Flavors' currency-neutral segment profit grew approximately 6%, led primarily by volume growth and the benefits from our ongoing cost and productivity initiatives. In terms of currency-neutral segment profit margin, we achieved margin expansion year-over-year of approximately 10 basis points to 24.3%. Fragrance currency-neutral sales improved 5%, driven by broad-based region and category growth. From a category perspective, Consumer Fragrances grew 5% on a currency-neutral basis. As growth was achieved in all categories, led by double-digit growth in Hair Care as well as mid-single digit increases in Toiletries, Home Care and Fabric Care. Fine Fragrances improved 1% on a currency-neutral basis against the very strong 11% comparison in the prior year period. Growth was led by double-digit increase in Latin America and low single-digit growth in North America. It should be noted that EAME and Greater Asia was soft. However, it was due to a strong year-over-year comparison of 19% and 25%, respectively. Fragrance Ingredients sales were up 10% on a currency-neutral basis, with growth in 3 of our 4 regions, driven by improvements in volume and higher pricing related to raw material costs. From a profit perspective, fragrance currency-neutral segment profits decreased 9% on a currency-neutral basis. As volume growth and cost and productivity benefits were more than offset by higher price to input costs, including the BASF citral issue. As I mentioned, as we move through the back half of the year, we expect the price to raw material cost dynamic to improve as pricing takes effect. In terms of currency-neutral segment profit margin, our profit -- our profile remains solid, yet was under pressure year-over-year. Before I move on, I want to provide some more commentary on the raw material environment. Coming into the year, we expected mid-single digit raw material inflation in 2018, inclusive of the impact of the citral situation, with the heavier base in the Fragrances business unit. Since that time, cost inflation has picked up following a series of disruptions in the supply chain. There have been the fires over several ingredients suppliers, increase in environmental actions of suppliers in China and to a lesser extent, rising oil prices. Based on what we're seeing today, we expect the incremental inflationary pressure as we exit '18 and head into 2019. It remains imperative that we achieve incremental price increases or identify other actions in unison with our customers to ensure we cover our raw material cost exposure over time. Operating cash flow was $55 million compared to $58 million for the first half of the year. Performance was primarily impacted by a product recall payment as we previously disclosed as well as costs associated with the bridge loan commitment fees, the combination, of which was approximately $40 million. In addition, there was an increased level of working capital. Working capital is primarily impacted by high inventory due to rising raw material in cost, increased volume associated with the prebuilding of inventory related to citral issue and higher-than-anticipated sales volumes. Over the course of the year, we expect all elements of working capital to improve. From a capital allocation standpoint, we spent approximately $67 million in capital expenditures or about 3.6% of sales. And we continue to believe we'll expand approximately 4% to 5% of sales in 2018 on CapEx. Regarding cash returned to shareholders in the first half, we spent approximately $109 million on dividend payouts and $15 million on share repurchases. As part of the Frutarom combination, we have paused our share repurchase program as we prepare for the financing of the transaction and prioritize debt repayments going forward. Also, last week, our Board of Directors authorized the 6% increase in the quarterly dividend to 73% -- $0.73 per share on the company's common stock. The increased dividend reflects the board's confidence in the cash generation potential and financial strength of the company. We will maintain a disciplined approach to capital allocation as we continue to accelerate growth through organic investments and strategic acquisitions, while returning significant capital to shareholders. As we look towards the balance of the year, I want to provide some commentary on our financial expectations, excluding the Frutarom transaction. All of our currency-neutral metrics have not changed. Based on our strong year-to-date performance and our current outlook for the second half of the year, we are reconfirming our previously stated full year currency-neutral guidance. As well currencies versus the dollar continue to fluctuate, we do to see an impact in terms of our top line. Based on current rates, we believe that we will have a 2 percentage point benefit on consolidated sales growth versus 3% previously indicated. While many currencies have an impact, the largest is the euro to U.S. dollar exchange rate. On an adjusted profit and EPS base -- and adjusted EPS basis, we anticipate the benefit of FX to be the same as previously communicated due primarily to our 12 to 18 months rolling hedging program and movements of various -- of other movements of various other currencies. For your reference, please note that we remain hedged at approximately 80% on the euro profit exposure at $1.15 for 2018 and are approximately hedged at 35% at $1.23 for 2019. With that, I'd like to turn the call back over to Andreas who would walk you through an update on the Frutarom transaction.

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

Thank you, Rich. First, I would like to reiterate that we continue to be very excited about the combination and it will create a global leader in natural taste, scent and nutrition with an expected 2018 pro forma sales of $5.3 billion and is a win for both companies' shareholders. Together, IFF and Frutarom will have a broader customer base, more ever supplied product offerings and an increased market penetration. We will instantly become a leader in natural solutions. It will also strengthen our exposure to fast-growing small- and midsized customer accounts, gain new opportunities in attractive and fast-growing adjacencies and enhance our global reach. We also anticipate cost synergies through raw material monetization, footprint optimization and streamlining overhead expenses. Additional cross-selling opportunities and integrated solutions are expected to drive revenue synergies to our shareholders over time. Most organizations have a strong talent base, comprising thousands of extraordinary employees globally. And so integration planning work, we continue to be confident in the opportunities that lie ahead and the ability of the combination to accelerate profitable growth, enhance free cash flow and generate greater returns for our IFF shareholders. Since the announcement of the deal on May 7, we really have made strong advancements to watch the deals close, and I would like to give you an update on a few. On Monday, Frutarom received shareholder approval for the transaction. Of the votes cast at the special general meeting, about 95% were in favor of the proposed merger, representing approximately 75% of all outstanding shares. We are pleased that Frutarom shareholders have approved the combination with IFF, marking another milestone in our path to unlock the value creaton potential of the combined company. We continue to have comprehensive pre-close meetings and discussions on talent, R&D, adjacencies and business and functional integration to ensure that when this transaction closes, we are ready to execute and drive profitable growth by capitalizing on the best of both organizations. We also want to take a moment to reiterate our intention to remain listed on the Tel Aviv Stock Exchange upon completion of the transaction. Given the progress to date, we now expect to close in the fourth quarter of 2018, earlier than our previously communicated timing of a 6 to 9 months from May 7 announcement. This timing continues to be driven primarily by the completion of the remaining antitrust reviews. To ensure the most successful integration, we have structured our approach in a very disciplined matter, with strong and dedicated teams. Foundational in our approach of 4 guiding principles: The first includes the establishment of a cross-functional team across both organizations, directly involving about 75 people committed 30% to 100% of their time to the integration depending on the nature of their role. To complement the support of this team, we have engaged external advisers such as the leading consulting firms across a variety of specialties. Our second core principle is to protect the core business and deliver the plan. As both organizations are entering the transaction as a position of strength, it's very important that we do not lose a focus and continue to deliver strong financial performance. At the same time, the integration team is responsible for realizing our targeted cost synergies and capture cross-selling opportunities. Leading the integration for us is Francisco and Amos for Frutarom. Francisco is the EVP of operation for IFF and has extensive experience in manufacturing, procurement plus strong cross-functional, robust commercial support and expertise bringing innovation to market. Amos is the EVP of global supply chain and operation for Frutarom and has a robust knowledge of the day-to-day operations at Frutarom and is actively involved in all business aspects. Together, both are excited and very engaged to ensure the successful completion and integration of our 2 great companies. Aligned with our second core principle to protect growth trajectory of both businesses, we are restructuring our day 1 model to ensure that once the transaction closes, Frutarom will remain as a stand-alone unit for now and will maintain their current to go market strategy. Given they are very customer-centric organization, it is critical that we limit the changes on the front end of the business. We want to ensure that there are 0 disruption to customers, and they continue to provide their products as effectively and efficiently as they have done in the past. Derived cost synergy realization, which I will cover in a more detail in a moment, we plan to leverage IFF's global expertise and shared service model. As time progresses, we will slowly centralize various group functions to further unlock value. Simultaneously, we intend to drive cross-selling through sharing our vast technologies and categories expertise across the organization. While growing through the integration process, there will be areas where we selectively lift and shift as appropriate based on the long-term strategy of the business. One example is the cosmetic active ingredient while we are moving Frutarom's business into our LMC infrastructure. As we outlined on May 7, we plan to unlock significant cost synergies related to the Frutarom acquisition. I'd now like to give you a bit more clarity on where the $145 million cost synergies target will come from and the estimated timing on this. We expect approximately 40% of the cost synergies targeted to come from procurement as we accelerate the rationalization and harmonization of raw materials across both organizations. Activities include make buy, vendor consolidation, centralization of spend, which will all contribute to the savings. Approximately 30% will come from operations as we have optimized the global footprint. Given the large infrastructure of both organizations, approximately on a [10]size on a combined basis, there are a lot of potential options to optimize our combined footprint. Out of the anticipated $145 million of our run-rate cost synergies, we estimate approximately 20% to 30% to come from streamlining of overhead expenses. It should be noted that less than 10% will come from business development as we had taken steps to ensure the preservation of the customer service levels at both companies. In terms of timing, we anticipate $145 million of run-rate cost synergies for the said full year after closing, with approximately 25 percentage shift in 2019, 17 in 2020 and the remainder in 2021. In addition to the cost synergies, and that's where I'm most excited about, we believe there's a strong potential derived accelerating growth by capitalizing on revenue synergies. Stepping back, not only does this combination create a global leader in taste, scent and nutrition, the combined organization will have the broadest customer base and strongest product offering and deepest market penetration in our industry. With respect to customers, we had IFF extremely well positioned with global multinationals. Out of our approximately 3,000 customers, 50% of our sales are global customers, where we are participants on nearly all global colors. The balance, our sales, always local and regional customers, strategic focus for us where we utilized the midtier go-to-market model, like Tastepoint. Frutarom, on the other hand, has approximately 30,000 customers, of which 20% -- 70% are small- and midsized and private-label accounts. By putting us together, we will have a very strong distribution network, ranging from the largest global customers to startups and private-label accounts. In terms of products, we pride ourselves in our ability to bring differentiating and unique innovation through the market, with approximately 8% of our sales spend on R&D, we have to develop industry-leading technologists across various areas, including modulation, delivery, natural cosmetics and so on. And our pipeline right now is as well filled as it was never in the history of IFF. Frutarom has a leading natural portfolio. 75% of their consolidated sales as well as access to adjacent technologies plus as natural Savory Solutions, natural colors, natural food protection and health ingredients. The combination will create a comprehensive portfolio, with the potential for integrated solutions to offer our customers one of the strongest portfolios in the industry. Together, both organizations will further penetrate key markets around the world. IFF's leading market share in Greater Asia and Latin America as well as strong positions in North America and Western Europe. Frutarom is a great complement as they have very strong exposure to key emerging markets and a complementary position in developed markets. While we haven't quantified the contribution of revenue synergies yet, we look forward to driving incremental growth by capitalizing on these 3 uniquely beneficial positions. I would like to provide an update on the antitrust approval process. We are currently on track as all applications have been submitted to the 8 countries that we needed to filing. In June, we have already received approval in the U.S., and have recently received approval in Israel. The rest, we are awaiting feedback and normal circumstances, expect to conclude the process in the first quarter. Rich, can you take us through deal financing consideration?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Thank you, Andreas. Given our progress to date, and as we prepare for our financing the transaction, we want to briefly give an update on the sources and uses of funds. From a source of funds perspective, we will be providing approximately $2 billion of new equity to Frutarom shareholders at closing the deal. We'll then be issuing about $2.2 billion of new equity issuance to the market. Of the $2.2 billion, approximately 67% is expected to become an equity and approximately 33% tangible equity units. From a debt standpoint, we'll be taking on approximately $3.1 billion of new debt financing. Within this debt financing, we'll be using combination of 10 and 30-year U.S. dollar bonds as well as euro public bonds with maturities. The remainder will be cash on hand from the balance sheet. In terms of uses of funds, we will deliver approximately $2 billion of equity and $4.3 billion of cash to Frutarom shareholders. Then, we will be retiring approximately $900 million of debt on both sides -- on the IFF side as well as Frutarom. All these was done while maintaining our focus on keeping on an investment-grade rating. Back to you, Andreas.

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

Thanks, Rich. Let's summarize. We are very pleased with our performance of the first half of 2018. Sales growth was robust at 6%, with growth across both business units. We also have achieved strong improvement in currency-neutral adjusted operating profit and currency-neutral adjusted EPS. Based on our year-to-date performance, our current outlook for the second half of the year, we have reconfirmed our previously stated full year currency-neutral guidance. On this strong foundation, we are pleased to have made great advancements towards the Frutarom deal closed, faster than our original expectations. We are very excited that together, the combination of IFF and Frutarom, will have a broader customer base, more diversified product offerings and an increased market penetration. It will create a global leader in natural taste, scent and nutrition, with a very attractive financial profile in terms of growth, profit and cash flow, which is expected to unlock significant value for our shareholders. With that, we will now like to open up the call for questions.

QUESTIONS AND ANSWERS

Operator

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

Mark Stiefel Astrachan - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Hey, so wanted to ask first just on a logistic standpoint. So sales growth expectations for the back half of the year, so there's a pretty large implied range from guidance. It's obviously much tougher comparison. So I guess, any sort of broader structure you can give on how to think about that, including how much pricing should we expect given the commentary about incremental input cost pressures and the underlying volumes as well as new wins?

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

Sure, Mark. I think a couple of things for me as I think about it. We've been talking since the end of the last year. Certainly, the first 2 quarters, that a big component of the higher growth in the first half of this year was the volume on existing business. So -- and we've even expressed and I certainly expressed an expectation that, that will soften. I think overall, on a 2-year basis, the numbers are fairly consistent first half, second half. But I do think the mix is going to change, where I think our win performance is pretty consistent and our good rates, our commercial performance are good. But I think in the second half of the year, we're expecting lower -- a decrease in the impact associated with volume in existing business and an increase in the pricing impact. As I said in the second quarter, we're about 1.5 points of pricing impact in Q2. And I would expect that to be higher than that in the second half of this year.

Mark Stiefel Astrachan - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. So I guess, kind of putting that together, it sounds like you're expecting to be 2 years to weaken somewhat or maybe not as much as, I guess, I would've thought given incremental pricing, is that fair?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Yes, very fair.

Mark Stiefel Astrachan - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And then just -- switching more to a strategic question, Andreas. I guess, I want to understand a bit more what gives you conviction in commentary you had before about sustainability of Frutarom as about 6% core sales growth in the context of what seems like some increase in competition within the natural space from competitors, not just through the (inaudible) but just sort of broader strokes as to customers out there move towards cleaner labels and more healthful products?

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

Yes. Well, I think that's a very fair question and an important question for us as well as we are redoing now our strategy. Let me answer in a way that, first of all, we have now probably the broadest customer base in the industry. So a lot of businesses was done with midsized and smaller customers, where we expect to have a higher growth rate going forward than our core business. Secondly, if you look at the categories, we have now a portfolio as a combined company -- or we will have after closing, which gives us the ability to move categories, which have good and high-growth rates. Like natural colors, for example. And we mentioned that natural color, that's still a trend which where we have, let's say, the exchange from synthetic to natural colors in the U.S. just in front of us where we will see high growth rates going forward. So the customer base and the categories give us a good confidence that the growth rate will be really, really good. Despite the competition in some of these areas, but the market is so big, that we believe that will not hamper our ability to have a fast-growing business in front of us. And if you're combining both, I believe it we can see our good uptake in the growth rate here.

Operator

Your next question comes from the line of Lauren Lieberman of Barclays.

Lauren Rae Lieberman - *Barclays Bank PLC, Research Division - MD & Senior Research Analyst*

First thing I would ask about was just the commentary on the incremental inflation. So it sounded like both there's incremental inflation versus the outlook 6 months ago for the second half of the year and also very much heading into '19. And so I just wanted to be clear on expectations at the back half. Is there incremental pricing going in? Do you have visibility? I mean, it sounds like you said you're reiterating, but how you're going to be covering that incremental inflation that's kind of closed in? And then also, as you're looking into '19, just tried to help us square the kind of rate of inflation we're talking about because if you're discussing needing to work with customers on outside of pricing, it suggests it's a pretty severe rate?

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Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Lauren, it's Rich. I think look, as I indicated in my comments, I think we started the year -- we ended last year, we started this year we expected inclusive of in the BASF issue to be mid-single digits. And it's now above that, given the other dynamics. I think what we feel good about is that, that the vast majority of our discussions and pricing negotiations with our customers have been completed. And so it's a matter of phasing those in. We've talked about that in the past. These things don't happen overnight, but we're confident in our ability to recover those increases over time. As I think about next year, I -- what were current view of what we're seeing today, obviously, I mean, we expect the BASF situation to normalize in the second half of this year. So that will leave some of the pressure. I think that as we see it today, input cost next year are probably going to be in a low- to mid-single-digit level.

Lauren Rae Lieberman - *Barclays Bank PLC, Research Division - MD & Senior Research Analyst*

Okay, great. And then I'm not sure if you'll be able to comment on this yet, but the Frutarom outlook, I think, sort of implies that they are baking in some incremental M&A before year-end. Is that -- to what degree do you have visibility on that because that's 1 piece of a sort of the forward look that left me a little bit less comfortable. Assuming M&A for something that's about to be bought, sort of a bit of a funny dynamic. So anything you can offer there will be great.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Look, in general, what we said when we announced the deal is that we is certainly want to go ahead with a model of good acquisitions on this business, in particular, on the adjacent businesses. Probably not at the same rate as Frutarom is doing it, because some of them were just geographic expansions where we probably don't need it because we, as a combined company, are very well covering the globe. We know and we had visibility of their pipeline in terms of deals. I can't give you any details, but there are certainly a good pipeline and there are deals to be happen over time, and that's what I can say for now. Yes, and we are planning our business model for money to be spent on M&A on this side as well, so that's what I can probably announce today.

Operator

Your next question comes from the line of Heidi Vesterinen from Exane BNP Paribas.

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

A question on the pro forma business as well. I think in the past year, you talked about increasing profitability through the combination. If you on the market about how high margins can go, some people are saying there's a cap. So where -- do you still see significant margin potential for yourself and more broadly in the industry, please?

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

Yes, Heidi. And in particular, when you look at the change in product portfolio and customer portfolio going forward, what we certainly see is that some of the adjacent businesses -- you have good margins and probably better margins than in the core F&F business. And now it's up for us actually to manage our portfolio in a way that we see a margin increase over time for the total corporation. I'll give you just 1 example. You might remember, when we moved 3 years ago into the active cosmetics, that's a very high-margin business, at least the piece or part where we are playing in. And we see now some of these businesses coming to us as well, with Frutarom. And now -- we are right now in the middle of the discussion in terms of strategy. One of the product categories we really want to push to move ahead on that time. Certainly, it's true on the core F&F business, it's not easy to push the margins are up and up. But we'll see -- let's say, the acceleration of the different portfolios. I think (inaudible), and then don't forget that we have a cost synergies for us as well and they will help us on the margin side, and particularly when you look at procurement and at the manufacturing footprint. Because that's another driver for us for margin. So probably of a long-winded answer, but I wanted to give you some details, but the answer is yes, we can move it up.

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

And if I could squeeze in a very quick short one. On the citral issue, is there any scope to get compensated after this disruption, perhaps from the supplier?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Yes. I mean, Heidi, we're looking at every possibility there in terms of obviously working with our customers. Our priority #1 priority has been to maintain surety of supply with our customers. And figure out the best way to work with them. From there, we'll look at any other option out there.

Operator

Your next question comes from the line of Mike Sison with KeyBanc Capital Markets.

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

When you think about the Slides 20 and 21, appreciate the update on integration and such. And so I understand you're keeping Frutarom on a separate makes a lot of sense. Can you give us a little bit of color how you plan to change the culture within Frutarom? A lot of different businesses that have been bought over the years, what's the sort of plan inside that box to integrate that and make that more efficient?

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

Mike, that's certainly something where we'll look into it right now, to look at what really makes sense to change or what makes sense to keep. We have to say that, there's certainly some elements, like the nimbleness and the customer focus we like a lot. We certainly will not change that. So there are a couple of elements, actually, within the culture where we have to take to consideration, whether we make them even bigger within the combined company. But we are in the middle of the assessment to do it. We will also, on day 1, integrate some business already, as I've said, we lift and shift. Plus it also makes sense and we can't jeopardize the top line growth because that's so important for both businesses. That's the reason why we have also kept our business people really focused on our core business and doing the integration basically in the back office work, okay? I mean, we can give you certainly more details over the next couple of months when we're coming closer to closing and after closing, certainly as well.

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

Sure. And then in terms of revenue synergies, you have 3 buckets that you talked about. Is there any particular -- is it going to be quicker to see the synergies? And how all 3 buckets -- all 3 buckets just sort of amount of feel for where and how soon in some these little areas can come in?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Well, good. It's actually an easy answer, but maybe not always as easy done. It's basically we give them access to our technology. And what we have seen so far, when we disclose some of our technology to them, there's a lot of excitement around that what they can do with it with their own customer base. Usually, they have a small- and midsized customers, so I expect actually pretty quick uptake of this kind of business or top line of synergy on this side. On the other hand, they have all the adjacent businesses, which we can sell into our bigger customers as well. And there's actually a lot of excitement on our bigger customers side as well, what they can do. There for example, an interesting committee that's called tower, they have a technology, which is very complementary to our PowderPure technology, which goes into natural solutions. And we are, right now, talking how we can bring this together and make sure that this gives a great offering to our customers. So there are a lot of discussions, but it means basically, our technology into their customer base and it means their adjacencies into our customer base, and what we are working on it. And we haven't put too much of the these revenue synergies already into our plan because we said we want to be really diligent to go over it, and then make really good plans, how to do it in the best way and when we have our, let's say, our first investor conference after the closure, we certainly will disclose some of it, okay?

Operator

Your next question comes from the line of Jeff Zekauskas with JPMorgan.

Jeffrey John Zekauskas - *JP Morgan Chase & Co, Research Division - Senior Analyst*

When you calculate currency-neutral operating profit growth, is the base what you actually reported last year? Or is it a different base that currency-neutral that's not immediately visible?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Yes, I mean Mike, what we do is -- no, Jeff, sorry. Sorry. Excuse me.

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

(foreign language) Rich has a little bit of a summer call. But if you (inaudible)

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Perfect timing for this. Yes, we take the prior year, and then we're adjusting the prior year results to current year exchange rates. Keep in mind though -- keep in mind that when you're looking at last year's reported numbers, the pension accounting change, which may -- which is a pretty significant number. We had the pension income is no longer reflected in operating profits, now in other income and expense.

Jeffrey John Zekauskas - *JP Morgan Chase & Co, Research Division - Senior Analyst*

Okay. I'll just say that since you're now of your own results -- rely so much on currency-neutral values, you might simply supply those values, so that your financial statements are somewhat more transparent. And since it's simply a translation to currency-neutral, I don't think it would give away anything competitive. Just secondly, can you describe what the tangible common equity units are in a little bit more detail? And what's the timing of your equity financing?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Sure. In terms of the financing, we expect to go -- to do the debt and equity raise -- equity first debt second, in the middle of September. The exact dates, we're still working through that. In terms of the tangible equity units, they're issued at a premium. And they have both the debt -- they both have -- they convert from a tangible equity units into common shares at the future. They have an interest component to that. And the premium allows the company to benefit up to a cap on growth in our share price over the 3-year period that gets the upside in terms of that -- as we deliver upon the plan, the shares reflects that, will have a lower dilution effect.

Operator

Your next question comes from the line of Gunther Zechmann with Sanford Bernstein.

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

From what you said about pricing from a material cost, I found that we're interesting. Do you expect higher gross margins in the second half this year compared to last?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Compared to last year?

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

Second half last year.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

No. I mean, I think, what we expect to see is that if you look at the year-over-year pressure that we saw in the second quarter, I would expect the second half of the year to be better than half or less year-over-year pressure.

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

Pressure from raw materials, but also -- less pressure, but also better pricing from what you've said? So higher cost in margins in the second half of '18 versus '17?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Yes. So if you look at the second quarter numbers, we were down about 200 basis points year-over-year in Q2. As we get the pricing in the second half of this year, I would expect that decline to decrease in the second half of the year.

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

Okay, that's very clear. And then just on the second quarter itself, on the gross margin, can you help us split out or how big the effects were between the ongoing raw material cost inflation and the citral impact? And I think you already mentioned the 1.5% pricing in Q2, if I have that, right?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Yes. So pricing is about 1.5 points.

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

So if you don't provide that bridge any more than you used to.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

All right. Yes, so let me give you the background. So yes, as I said, 1.5% of price increases, when you -- as I just mentioned, we're down about 200 basis points year-over-year in gross margins. All of that can be attributed actually most likely (inaudible) but all of that can be attributed to net price to input cost, the dynamic. And as best as I can -- we can estimate it, it's split roughly 50-50 between the citral issue and the other price increases. And as I said, it's a timing issue that we expect to normalize over the balance of the year and into early next year.

Operator

Your next question comes from the line of John Roberts with UBS.

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

Your mysterious larger shareholder increased their position in your stock again recently. That surprised me a little bit given they'll be able to buy all they want in the secondary offering in a month or so. Have you talked to them about participating in the secondary?

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

It's Mike. From a largest shareholder perspective, we've had pretty lengthy conversations with them with respect to every ongoing institutional investor we have. They remain passive evident with their filing of their 13-G so there's no change there. With respect to secondary offering, unfortunately,, we don't disclose the process, but what I can say is that there's technical rules that they have from buyback even in their side. So it's ongoing conversations as we move forward. More to come.

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

Okay. And then secondly, are you concerned at all about the persistent low growth in Greater Asian Flavors business? You had an easy comp this quarter it was against minus 2% a year ago and you haven't had a comp above 2% over 1 year.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

No. Actually, not because we are happy that finally, we were turning -- or we are turning around the situation in China. The good growth in China and the Flavors business. What is (inaudible) let's say an issue for us was Indonesia because we have a big business in Indonesia and the market is pretty, pretty soft. That was taking the growth rate down. But eventually, that will come back. The rest of the Asian business is performing very well. And as I said, particularly, John, China, we are happy to be back. Interesting enough is, you might recall that the whole thing goes back to our factory issue we had in 2015. So it took us longer to recover. We have now a second manufacturing plan actually in place. And we will open it in the fourth quarter of this year, so we have a backup plan. And we believe that the China will be, for us, a good growth country going forward. And now even with the consolidation of Frutarom, even better, because we will get some of their volume, basically, into our factories as well.

Operator

Your next question comes from the line of Adam Samuelson with Goldman Sachs.

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

Maybe just a clarification on the guidance, a lot of ground covered today. There is a pretty sharp deceleration implied in second half currency-neutral sales growth and understanding the comps get considerably tougher, especially in the fragrance. But you've got better pricing -- expected to flow through. Is it such that you think volumes are actually down year-on-year in the back half, either company-wide or at least in the fragrance? And if so, is it just comps? Is there anything on win rates or customer order patterns that would make you think that? I just want to make sure that I understand some of the moving pieces in there.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Look, as I said -- as I mentioned earlier and when look at it on a 2-year basis, it's not there's any significant change. What I do believe -- what we do see happening is that, the first half of this year, lower comps, but a bigger chunk of the improvement was volume on existing business. The growth -- the volume on existing business were above, let's call it, 5-year norms. Our win rates and impact of new wins was consistent with the 5 long-term trends. So we're not seeing anything slowing or increasing there. And so we expect to see a slowdown in the volume on existing business. That would be offset by pricing.

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

Okay. And then just below the line, tax rate has come in. I think below kind of the expectations at the beginning of the year. Is there an expectation that you see a lot of pickup in tax in the back half? Or what's the full year expected rate?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Yes. So for the first half of the year between '18 and '19, I would expect we're going to end the year between '19 and '20.

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

And there's no -- the financing for Frutarom obviously is not embedded in the EPS outlook for the year, is that correct?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Everything related to that is excluded at this point.

Operator

Your next question comes from the line of Fintan Ryan with Berenberg.

Fintan Ryan - *Joh. Berenberg, Gossler & Co. KG, Research Division - Analyst*

Firstly, in terms of like the integration with the Frutarom deal, on the Frutarom side, given that we are a few months further down the line, have you thought about it? Or have you seen any impact us for in terms of Frutarom in turnover? And would you be confident that most of the other core management team there will remain with IFF and help the integration process post acquisition, particularly given the sort of the Frutarom shareholders projected the bonus between proposed for CEO of Frutarom? How does he -- does IFF intend to keep him compensated and interested in the business? And then in terms of the regulatory approvals, would you anticipate any issues in terms of some of the larger markets where Frutarom operates in terms of -- like Russia and the European Union? Is there potential for any divestments that you can see at this stage? Or do you think it's just merely box ticking exercise to get the regulatory approvals?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Let me start with the last one. First, on the regulatory side, we don't see any issues, and we don't expect to have -- to divest any business before we get to regulatory approval, which is positive. And that made us, actually, believe that the fourth quarter is good for closing, which is ahead of the initial timeline we have given ourselves. We are very happy about that. On that talent side, for the integration, we haven't seen any significant departures. And we believe that many of the senior leaders will have a good position within IFF and will stay. And we are very happy with many of the talented people who will join the new IFF in the new makeup of the company and help us driving growth.

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

From my standpoint, I mean -- I think we're also, we have a completely separate work stream around talent management and the people. As Andreas previous comment in his prepared remarks, very strong talent base. Part of that work stream is identifying who those key people are and reaching out to them and having discussions before closing in terms of what the vision is for the future.

Operator

Your next question comes from the line of Faiza Alwy from Deutsche Bank.

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

I just wanted to go back first to pricing in the quarter. If you could just update us on -- or give us more color around where the pricing is coming from? Like is it more -- my sense is that's may be coming more from the smaller customers, and then you expect in the back half to get more pricing from your more global customers? And then maybe if you could disaggregate sort of how much of it is coming from Fragrances versus Flavors? And within the Fragrances, how much is Fragrance Ingredients versus the other components?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Sure, Faiza, I'd say in general, this pricing is Fragrances versus Flavors. And then within that, it's a balance between compounds and the ingredients business with as you know we've talked in the past Fragrance Ingredients business generally works off a 6-month contract, so they generally -- the impact has seen sooner on in the ingredients side. On the fragrance compound side, it's the timing is often driven by one, the process to identify where and when the choices are made about the adjustments. And in some cases, can be driven by the indices or the contract on when the windows open up. So -- but it's -- the details on global versus local, regional, it's hard to say. So I think it's more around those 3 businesses, more Fragrances than Flavors and more of what we see today on ingredients versus compounds.

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

Okay, understood. And then unless I missed it, I don't think you reiterated your previous outlook around double-digit EPS cash accretion in year 2 post the deal. So I was just wondering if that still stands? And if it does, maybe you could walk through some of the components of that? We understand the synergy facing, but maybe you can just update us on what type of underlying growth you're expecting? And maybe if you baking anything for incremental acquisitions there.

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

Mike here. But it's still stands -- let's put that -- that's clear. And Rich can explain...

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

We reiterated our guidance around in our core business. We were not talking about the Frutarom deal that we'll cover, as Mike said earlier and Andreas said we'll cover that after the deal closes. But in overall, the big -- a big part of the year-over-year on a cash basis the accretion is driven by the synergies. When we go from 25% to 70%, the cash flow generation of the business is quite significant. We expected to pay down the debt quite significantly, pretty quickly. So we'll get both the operating profit gain as well as the interest expense reductions that are driving it.

Operator

Your next question comes from the line of Patrick Lambert with Raymond James.

Patrick Gerard Jean Lambert - *Raymond James & Associates, Inc., Research Division - Research Analyst*

A few questions. (inaudible) just going back on the citral and every company has a different timing of impact to the (inaudible). And do you think that actually for you guys, the bulk of the impact -- I think it was last year about $45 million for the year for Frutarom without any mitigation. But is it more in Q2 throughout the rest of the year? Or is there still more to come in terms of just for citral impact that's the question number one.

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Yes, I think the answer for the first part as we last on the last call, I mean the impact was a small in Q1. As I talked about it at that time, most of the higher costs were sitting in inventory. So I think when you think about the overall impact, Q2, Q3 are the pressure points. And then on the input cost side, the -- we expect it will be purchasing cost to come down as the citral line stabilizes. And then on the other side, we get -- we start to fully recover -- we get the pricing takes hold and that will further mitigate the impacts.

Patrick Gerard Jean Lambert - *Raymond James & Associates, Inc., Research Division - Research Analyst*

And you still believe you can -- either the 7% we cover about 5% of impact, the percentage points of your bridge?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

And we still believe that currently the impact in the year, this year, will be about a 2% headwind. So somewhere between $10 million and $15 million on operating profit.

Operator

Your next question comes from Jonathan Feeney with Consumer Edge.

Jonathan Patrick Feeney - *Consumer Edge Research, LLC - Senior Analyst of Food & HPC and Managing Partner*

I wanted to -- when you think about your sales forecast, maybe this is a question more for Rich or may be Andreas. Do you have implicit in that and assumption about the acceleration or deceleration in your end-customer markets? How much visibility do you have into that? And finally, could you characterize of the growth in your portfolio, in your customers right now between small or local -- either small, local or both kinds of customers versus global customers? And I ask because it seems like persistently, your growth rate is so much better than that if I put together just a slap or put an index together, it would appear all your major CPG customers. You've been growing a lot faster for a long time on an organic basis. So just trying to get my hands around that and how do you think about that as your forecast?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Sure, Jon. So first of all, what we see certainly is that the small- and midsized customers are providing us with better growth than the big ones. And now with some of the moves we have done in our own core business, like Tastepoint, for example, we are covering better this small- and midsized customers, which gives us some good growth there. So that's good. And actually, there's that's one of the reasons for the Frutarom deal, because that will give us even more exposure towards these customers. And we feel very excited about this. In general, if you look at the volume trends, they are pretty robust. I would say also with our end customers. Since I would say probably third quarter last year. And we see still pretty, pretty robust volume trends. We saw it in our first quarter, for example, where saw things in our inventory much faster than we saw particularly on the fragrance side. We don't see a deceleration of these trends, but you never know. So I think that's certainly, for us, something we have to see and we have constant dialogue with our customers all the time to figure out where they spend and how much growth they see going forward. But so far, the volume trend is intact for our customers, which is actually good news for us.

Operator

Your next question comes from the line of Brett Hundley with the Vertical Group.

Brett Michael Hundley - *The Vertical Trading Group, LLC, Research Division - Research Analyst*

I just have 1 question. I'm trying to think more about your -- the ability of your fragrance segment margins to rebound in 2019. And Rich, I thought you had an interesting comment on pricing, when you talked about raw material inflation continuing in the fiscal '19. And I don't know, I'm just reading your comment as very public and signaling, and talking about how it's imperative that you get pricing through a lot -- or look at other actions. And if I'm not reading too much into that comment, is there -- as you guys have pricing discussion -- ongoing pricing discussions with customers, do you feel like you're getting to any type of prices ceiling on the synthetic side? Or do you feel like you're running into any challenges on taking pricing higher? And may be related to that, if it's not pricing, do you guys believe that you can deliver another round of cost savings following what you've done over '17 and '18? Are you feeling better about, may be, walking your synergy number from Frutarom higher? Or maybe walking it faster? Can you just talk about the other way that if you don't go out and get pricing, that you might be able to offset further on coming inflation?

Richard A. O'Leary - *International Flavors & Fragrances Inc. - Executive VP & CFO*

Sure. Thanks. Look, I'm never going to sit here in my role until you're getting the price increases easy. It's not. It's a long process. I think we're better -- there are better tools available to us today to help our teams have fact-based conversations with our customers at a very detailed level that we hadn't had 6 or 7 years ago. And that -- that's imperative to our ability to get those price increases. Would I like them to come sooner? Absolutely. But we have to manage our business and these are long-term relationships with our customers, and we have to work together. And sometimes, some cases, it can come quicker. In some cases, we have to make a choice and work with them around in the formula optimization or open it up to formularies. And reformulating. Sometimes, we have to look at options around phasing in the price increases. But I think the business -- both businesses have shown the ability to recover the price increases. Again, sometimes, the timing was probably not what Andreas and I would like. But I think we're able to do it. Now from a margin standpoint, obviously, it's dilutive.

Now from a margin standpoint, obviously, it's dilutive, because what we don't do is try to markup the cost increases. So I think those will continue. We'll continue to work that next year. I think what's important to me -- I think when I look at the trajectory on the input cost increases, again, we're not sitting here saying they're overexpecting it to be double-digit increases across 80% of the portfolio, which is what we faced back in '10, '11 and '12 and that took us 2 or 3 years to recover that. So I think we will continue to do that. In terms of your question around cost savings and what we do as a business, I mean, that's part of what we're constantly doing, is managing productivity programs. I mean, at the productivity programs that Francisco's led over last 11 years that I've been with the company, I've been dramatic in terms of what they've delivered to the bottom line and helped us give us flexibility. I'm not going to sit here and tell you we have the same ability to achieve those that we haven't had in the last 10 years over the next 10 years because we've done all the easy stuff. But it's a constant part of our agenda. And then obviously, we will obviously look to accelerate the synergies and turn over every possible zone to have as much flexibility in our operating model. And I think we will then look at how much do we reinvest in the business. That becomes, to me, the variable of terms of, okay, if we're ahead of schedule, we can potentially reinvest quicker. If we're behind, we'll be more stricter in terms of where we make incremental investments.

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

Actually, on the cost side and particularly on manufacturing, as Rich said, the easy stuff is done. But now, in front of these -- the 4 Industrial Revolution, we see much more of a drive into artificial intelligence and robotics, which will help us actually significantly to decrease some of our costs we're having in that area. And that's actually a very, very helpful. So our profitability and potential savings agenda is still on for the core business. And then on top of it, certainly the savings we get from the Frutarom deal. That's where we are. And we feel actually very, very good about it.

Operator

And we have reached the allotted time for Q&A. I'd like to turn the call back over to Andreas for closing remarks.

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

Yes. Thank you for all the great questions. It was a good session. I hope you got the answers you needed. And as usually, we follow up with the one-on-one calls for more detailed information. Thank you very much, guys. Have a good day. Bye-bye.

Operator

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