FINAL TRANSCRIPT

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IFF - Q2 2010 International Flavors & Fragrances Earnings Conference Call

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PRESENTATION

Operator

At this time I would like to welcome everyone to the International Flavors & Fragrances second quarter 2010 earnings conference call. All participants will be in listen-only mode until the formal question-and-answer portion of the call. Participants will be announced by their name and company. In order to give all participants an opportunity to ask their questions, we request a limit of one question per person. I would now like to introduce Michael DeVeau, Investor Relations Manager. You may begin.

Michael DeVeau - *International Flavors & Fragrances - Mgr IR*

Thank you, operator, and thanks everyone for joining us this morning. With me on the call today is our Chairman and CEO, Doug Tough, our Group President of Fragrances, Nicolas Mirzayantz, our Group President of Flavors, Hernan Vaisman, and our Executive Vice President and CFO, Kevin Berryman. Please note that this call will be recorded and will be available for playback on our website. Please keep in mind that during this call we may make some forward-looking statements about the Company's performance particularly with the respect to the second half of 2010. These statements are based on how we see things today and may contain some elements of uncertainty. For additional information concerning factors that could cause actual results to differ materially from forward-looking statements, I ask you to refer to the cautionary statements and risk factors contained in today's earnings release and on IFF's website. Some of today's prepared remarks will exclude those items that affect comparability. These items are laid out in our non-GAAP reconciliations which is also available under the Investor Relations section of our website. With that, I would like to introduce Doug.

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Thank you, Michael. Good morning and good afternoon to everyone. Now, before moving on to discuss our Q2 results I would like to update you on one of the priorities we discussed on our Q1 conference call. Since joining IFF full-time back in early March, we've begun to pressure test our current strategies and our business model to ensure we are operating to the best of our ability. As part of this review we have engaged a strategic consultant to aid with us the process. While we are still in the initial phases of gathering data and understanding the complex dynamics, we believe we are working towards an optimum path that will lead to greater shareholder value. We are thoroughly examining our regions, our categories, and our customers relative to the drivers of our current and future levels of profitability. Specifically, we are looking to optimize our resources to ensure we are putting emphasis where we will get the best overall return. We are evaluating the relative levels of human and capital resources that are required to deliver our current results. Perhaps but not surprisingly, we have discovered very different performance results, where as some categories, some customers and regions are creating much better returns than others. Please note, however, that much work still needs to be done. My expectation is this project will continue throughout the balance of this year. We will do our best to keep you informed of our progress and how these results will lead to even greater financial performance, that in turn will drive further shareholder value. I can assure you this is the highest internal initiative at IFF, and I am pleased with the efforts and the progress made thus far by the entire organization.

Turning to our second quarter results, I would like to note some key non-financial accomplishments that I believe will position us well into the future. First, in Flavors. I am happy to report that we have been selected as a global core supplier for a multinational Flavor customer, making us one of only three suppliers on that coveted list. This is great news for IFF and speaks volumes about this customer's trust in our ability to deliver quality, innovative products that help them differentiate their brands in the marketplace. Adding to our portfolio of health and wellness solutions is our newly signed licensing agreement with Redpoint Bio, developers of an all-natural sweetness enhancer derived from Stevia that will be exclusively ours for five years. The addition of this product will enable us to offer our customers more natural solutions to reduced sugar products. I would also like to mention that the Fragrance team once again showed that IFF is a thought leader in looking to the future of Fragrance as they demonstrated in their well received hedge-based symposium presented earlier this year in concert with the Museum of Modern Art and the Parsons School of Design. For those of you who do not know, the hedge-based symposium gathers leading thinkers, designers, scientists, artists, and established perfumers to challenge the conception, impact and potential applications of scent by exploring new territory for design. Opportunities such as these are great ways to think outside the box, leading to the key innovations so necessary to our business. While the rest of the IFF Senior team will take you through the full details of our Q2 performance, I'll provide a few high-level comments.

It is clear that the strong momentum we experienced in the beginning of the year continued into the second quarter. While we have benefited from restocking and favorable comparisons against a soft base period, the team was successful in winning key new business that helped drive this record top-line performance. This growth on the top line, alongside our continued focus on cost and productivity supported a strong improvement in the operating profit margin. The end result was very positive. Adjusted EPS increased 31% year-over-year. Finally, before passing on to Nicolas who will provide further context surrounding Fragrances in Q2 results, I would like to acknowledge our global supply chain and manufacturing team. With so much activity in both Flavors and Fragrances, you might deduce that this strong volume would cause a strain on our supply chain and you would be correct. We experienced unanticipated demand, which was taxing our manufacturing plants and material sourcing. Despite that substantial increase in demand, I'm happy to report that we kept up our service levels to our customers. The supply chain and manufacturing team have risen to the challenge and have held our excellent customer service levels. Once Nicolas, Hernan, and Kevin conclude their prepared remarks, I will come back to provide some perspectives on the future and our outlook for the balance of this year. With that I would like to introduce our Group President of Fragrances, Nicolas Mirzayantz.

Nicolas Mirzayantz - *International Flavors & Fragrances - Group President - Fragrances*

Thank you, Doug. Good morning and good afternoon, everyone. I am happy to report that local currency sales in the second quarter increased 23%, one of our highest achievements in Company history. As all categories, all regions, and all customer segments on the consolidated basis reported double-digit growth. Our very strong performance was driven by the team's ability to execute against key strategic initiatives developed two years ago as well as their ability to win important new business. In the fine Fragrance and beauty care category local currency sales grew 37%. Robust trends in fine Fragrance continued, growing at a strong double-digit rate as our ability to secure many of the key 2010 launches drove results. While new business gains did also report the very strong fine Fragrance results it is important to note that a portion of this improvement can be attributed to weak prior year comparables as well as some elements of restocking. Despite these benefits, I am confident that we should continue to perform well as a strong new business wins should provide a solid foundation for future growth. In beauty care, hair care and toiletries continue to perform very well, both increasing at a strong double-digit rate. We continue to win important new business that has strengthened our leadership position across all our global and regional customers, and I believe many solid opportunities still exist. Our functionally foreign business continued to grow double digits, increasing 12% despite a more challenging year-over-year comparable. Fabric care performance remains strong as key new wins in Europe, Greater Asia, and Latin America aided results. In home care, we have seen a return to growth following a challenging 2009 as we continue to benefit from the addition of an important [co-lease] two years ago. In personal wash, solid growth was achieved despite a strong 2009 comparable.

Our excellent performance in functional Fragrance continues to reflect our strategic investment in innovation. In particular, with our micro encapsulation technology. In the second quarter this technology represented a large component of our growth and was one of the driving force of our above-market growth levels. Finally, Fragrance ingredients local currency sales increased 24% driven by a favorable comparison for the year-ago period as well as improvements in underlying demand. Looking at the geographic breakdown of our sales, I am very pleased with our performance across all regions. In the developed markets of Europe and North America, we experienced very strong double-digit growth of 29% and 19% respectively, driven by new wins and volume growth. Complimenting the success, the strong trends in the emerging market of the previous four quarters have continued. Brazil, Russia, India, and China all continue to show double-digit growth, driven by new win performance and increased demand from both global and regional customers. As a result, we enjoyed a growth of 19% in Asia and 18% in Latin America.

Operating profit increased by $28 million to $65 million, including approximately $2 million related to ongoing restructuring efforts in Europe as compared to $5 million related to restructuring charges in the prior year period. Excluding these items, adjusted operating profit grew nearly 60% or $25 million to $67 million as higher volumes, improving input costs, and benefits from previous cost reduction initiatives drove results. Adjusted operating profit margin for the quarter increased 430 basis points to 18.6%, a level we have not seen in nearly five years. As we enter the second half, we have started the quarter with good momentum. It is important to note, however, that we expect the benefits of restocking to slow. In addition, as we face stronger prior year comparisons, we do expect local currency sales in the second half to be lower than the first half as our strong performance in both Q1 and Q2 is not sustainable. Nevertheless, we believe our strong pipeline of new business should continue to position us well as we advance in the third quarter. I would now like to turn the call over to our Group President of Flavors, Hernan Vaisman who will provide an update on the Flavor business.

Hernan Vaisman - *International Flavors & Fragrances - Group President, Flavors*

Thank you, Nicolas. We are pleased to say that local currency sales in the second quarter increased 11% as compared with the 2009 period, marking the 20th consecutive quarter of local currency growth. Strong trends in EAME and Greater Asia continued as increased volume and new business wins once again led to double-digit growth. In North America, local currency sales returned to positive growth increasing 7%. As our team did an excellent job working with our customers to win new business. Specifically the double-digit performance in both Confectionery and Beverage were impressive and gave out confidence that we look to increase market share opportunity. In EAME, local currency sales increased 18% over the prior year quarter as both

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categories reported double-digit growth. The Beverage category continues to be a standout as new wins and stronger volume are driving results. This marked the third consecutive quarter of double-digit growth for this category. Regionally, emerging markets of eastern Europe and the Middle East grew 25% flat, while the developed market, western Europe, grew in the high teens. Sales in Latin America were once again positive, growing 4%, as new business and volume recovery in Savory, Confectionary and Dairy upset the last known strategic business that began in the third quarter of 2009.

Please, note that this, our final comparison that includes the loss of (inaudible), so we expect growth to accelerate in second half as a result of critical wins in key categories. Lastly, in Greater Asia, local currency sales were up 12% as all categories reported positive results. Recent momentum of our business in most Asian countries contributed substantially to the double-digit growth in this important part of the world. This was fueled by higher volumes and new wins across all categories. The Flavor teams continues to do an excellent job capitalizing on new business opportunity to drive above market growth. While I am happy to report our highest sales growth in Company history, what I am most proud of is our performance across all regions and all categories. Turning to profit, Flavors operating profit increased 18% or $10 million to $60 million in the second quarter. This increase was driven by accelerated sales growth, improved input costs, and our continued margin improvement initiatives. As a result, operating profit margin improved 100 basis points to 21.2% versus 20.2% in the prior year period. While we are entering Q3 we have started the quarter with solid momentum. Our project pipeline remains very healthy, and I believe we're in a good shape to continue our track record of local currency sales growth as we move into the second half of the year. With that I would like to turn the call over to Kevin.

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

Thanks, Hernan. On our Q1 conference call I highlighted four key trends that we expect to see in 2010. I would like to update you on how we are progressing in these areas. First, we communicated that we expect local currency sales to trend above our long-term growth target with relative strength in the second quarter driven by favorable prior year comparison. This indeed has happened as each of the businesses were able to realize substantial improvement in Q2. Second, we highlighted that we would see an improving input cost picture. Specifically lower input costs were combined with our accelerated sales performance allowed us to improve gross margin by 270 basis points over the prior year period to 42.8%. Our continued focus on cost discipline helped mitigate some higher than normal RSA costs, most notably incremental incentive compensation provisions, as we delivered 90 basis points of adjusted operating margin improvement finishing the quarter at 16.5%. As a result, adjusted EPS for the second quarter increased 31% year-over-year to $0.85 per share.

Looking at our local currency sales trends over the past five quarters, I would like to note that all categories in Q2 are showing double-digit growth. However, restocking of favorable comparisons in fine Fragrance and ingredients certainly aided results. As we enter the second half it is important to note that the benefits of restocking appear to be subsiding. When combined with stronger prior year comparisons, and continued economic volatility, we expect local currency sales growth in the second half to grow at more normalized levels with relative strength in Q3 versus Q4. Turning to input costs, we continue to see period-over-period decreases in the P&L driven by a reduction of higher cost inventory. As expected, input costs represented a 7% decrease in the second quarter. Looking ahead, we believe input costs should remain favorable for the full year, although the selective pressure in the second half may reduce the rate of favorability for the full year. Specifically, fluctuations in oil prices could place pressure on some oil related materials and freight surcharges. While we're experiencing benefits in 2010, I would like to remind you all that our overall input cost position remains above historical levels. From an overhead cost standpoint, RSA as a percentage of sales increased 160 basis points to 26.3%. The $35 million increase is mainly attributable to additional incentive compensation provisions of $18 million plus litigation related costs, investments in spending to support the higher level of business activity, reduction of R&D credits, unfavorable foreign currency movements, and lower prior period base spending.

It should be noted that included in our RSA expense this quarter is roughly 250 basis points of expense versus what we've considered more normalized levels. This increase can be attributed to additional incentive compensation provisions above normalized levels. Obviously driven by our very strong performance in Q2 as well as additional litigation related costs. As our top line performance returns to more normalized levels, we believe our cost structure will follow. Within RSA, R&D expense as a percentage of sales increased 60 basis points at 8.4% driven by incremental incentive compensation provisions, a reduction in R&D credits and incremental investments in support of our strategic growth initiative. Looking towards the second half we will continue to maintain strict discipline in the management of our fixed cost structure. If our performance is similar to the performance experienced in the first half, we would expect, however, additional costs associated with compensation provisions. Moving to currency, while the Euro devalued against the US Dollar during Q2, the negative impact on our P&L was largely offset by the strengthening of other currencies. In the past we have said that for every 1% strengthening or weakening of the US Dollar we expect a plus or minus $0.02 impact on our EPS on an annual basis. Please note that this can vary depending upon the mix of currencies and balance sheet impacts that are driven by point in time translation factors. The exact impact depends upon the consistency of the [paring] change across the major currencies in which we operate. Looking ahead, if currency rates stay where they are today, including the Euro at $1.32, we expect to face modest pressure in the second half 2010.

As we have communicated on our Q1 conference call we have evaluated the possible hedging strategies that could provide for decreased volatility in this area. We have begun to implement these strategies and believe that volatility should be reduced as we begin to enter the fourth quarter. Nevertheless, at current rates, we still believe that the above mentioned currency rules should be directionally accurate in Q3 and Q4 of 2010. Turning to our EPS reconciliation, as highlighted on the slide, we continue to see improved performance, including the abnormally high levels of incentive compensation provisions and legal related costs, previously noted adjusted EPS still improved $0.20 or 31% versus the year ago period. As we move from our adjusted EPS to our reported EPS I would like to note that the $0.02 difference is entirely related to our previously announced European rationalization. As a reminder, to date we have recorded a $20 million provision of which $2 million was recorded in this quarter. We now expect our total cost for this initiative to be approximately $31 million to $34 million with targeted annual costs savings of $17 million to $20 million annually beginning in 2011.

From cash flow perspective we continue to make improvements in working capital efficiency. As a result, a larger component of our success -- a large component of our success, in the second quarter came from our ability to better manage our receivables and payables. This improved efficiency combined with the relative business strength in the quarter drove a $40 million increase year-over-year in cash flow from operations. As a result of this strong cash flow dynamic and the confidence in our long-term outlook our Board of Directors authorized an increase in the Company's quarterly cash dividend, raising it 8% from $0.25 to $0.27. This marks the fifth increase in six years that the Board has raised the dividend and reflects our continued commitment to return cash to shareholders. One point regarding our capital expenditures, we are, we believe, on track with our goal of approximately spending 4% of sales for the year. With that I would like to turn it back over to Doug for a perspective on the balance of the year.

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Thank you, Kevin. Looking towards the balance of the year we believe that the operating environment in the second half is likely to be different than what we have seen in the first two quarters. In particular, we expect to face more challenging comparables as our sales performance improved during the second half of 2009 last year. In addition, while it is difficult to say to what extent our first half performance was aided by restocking, it is clear that this benefit will not continue indefinitely as we progress through the balance of 2010. As we begin Q3, while business momentum appears solid driven by our strong new win performance with substantive restocking benefits that aided Q1 and Q2 would appear to be subsiding. Finally, as economic and political volatility around the globe remains, we expect currencies to continue to fluctuate. As a large portion of our results are denominated in Euros this will represent a headwind during the second half of 2010 at current exchange rates when compared to year ago. That said, as Kevin mentioned, current hedging strategies should begin to reduce the volatility later in the year. So what does all this mean?

In order for IFF to be successful, we must continue to execute our plans, anticipate challenges, and win in the marketplace every day. We will focus on the areas we can control and will continue to be disciplined in the management of costs as we look to mitigate some of the external pressures. The net result is that while we are cautious in our outlook we believe the strength of the first half combined with our disciplined approach in the second will allow us to deliver results that have not been achieved over the last decade. Specifically, we should see our local currency sales finish this year well above our long-term target and EPS will grow at a strong double-digit rate. In summary, as we reflect back on the first six months of 2010, I would like to take a moment and congratulate the entire IFF team for all of their accomplishments. Our performance year-to-date has been very strong, driven in large part by the hard work and dedication across the organization. We would not have been able to achieve these strong financial improvements without excellent contributions from our employees. Suffice to say, our Board were complimentary to the organization on the breath and the depth of the results. As we look forward to the next six months, we continue to remain cautiously optimistic. While we have entered the second half with solid momentum, our visibility through the balance of the year remains limited given the evolving landscape, particularly in developed markets.

In addition, as the restocking phenomenon must abate, we believe that the progress achieved in the first half, new wins in particular, should continue to drive our disciplined growth strategy. And we are further excited about our growth prospect flowing out of our intensive strategy development project currently underway. Our goal entering 2010 was to return to local currency sales growth and improve on our overall profitability. While we're only six months into the year, we are confident that we should surpass these initial goals and achieve results above our long-term targets. And with that we would be happy to take any questions that you may have. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question is from the line of Jeff Zekauskas with JPMorgan.

Silke Kueck - *JPMorgan - Analyst*

Good morning, this is [Silke Kueck] for Jeff. How are you?

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Well, thank you.

Silke Kueck - *JPMorgan - Analyst*

I have a couple of questions. Your sales gross in the quarter, for the first six months has been noticeably better versus your competitors and to some extent, even versus some of your customers. Particularly your European customers if you look at Unilever or others. What do you attribute this to?

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Well, we think there are really a number of factors there, and the performance has been strong, as you have noted. We've touched really upon a weak base year ago when there was de-stocking, and hence we would see some restocking that's happening now. We think we've also had a level of overall improved performance by our customers, though not to the level that we've achieved, as you've mentioned. Lastly, obviously a significant number of product wins and category wins in both Flavors & Fragrances. I view those as top line comments and invite Hernan or Nicolas to add anything.

Hernan Vaisman - *International Flavors & Fragrances - Group President, Flavors*

(inaudible) I think that of course in the growth we see some elements of restocking and favorable comparisons, but also this performance can be attributed to solid wins that we have as I mentioned in almost all regions and categories.

Silke Kueck - *JPMorgan - Analyst*

Is the restocking component about like in a half of the organic growth that you saw? And how did prices do for the quarter?

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

Silke, this is Kevin, good morning.

Silke Kueck - *JPMorgan - Analyst*

Good morning.

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

We talked about an overall picture as it relates to what volume and or commercial performance look like, and you will note in the Q that there is a discussion of -- on a global basis, consolidated basis, roughly 40% of the growth is associated with new wins, commercial performance. And, of course, that then results in there being a remaining 60%. There is some element of restocking in there. We do not know what it is. But certainly there is some element of it.

Silke Kueck - *JPMorgan - Analyst*

That's helpful. If I can ask a last question, the Company has done an excellent job in benefiting, got some higher margin as volume growth has been very strong and raw material costs have been favorable. Are these current margin levels sustainable as volume growth moderates?

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

Silke, this is Kevin again. I think that clearly we realize some benefits in the quarter in terms of growth leverage against our manufacturing infrastructure. And I think that certainly that has provided some benefit specifically in this quarter. I would also remind you, however, as it relates to the future, that our European rationalization and restructuring initiative, which basically will be completed, we believe, we continue to believe, by the end of this year that will translate into incremental margin opportunities in 2011. So there is some ability to continue to drive improvements, which will help offset perhaps some of the loss we'll get because of this extraordinary level of growth.

Silke Kueck - *JPMorgan - Analyst*

If I understood what you said, you believe that margin levels are sustainable given that there are more restructuring benefits going forward.

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

Yes.

Silke Kueck - *JPMorgan - Analyst*

That's very helpful. Thanks very much. I'll get back in queue.

Operator

Your next question is from the line of Mike Sison with Keybanc.

Mike Sison - *Keybanc - Analyst*

Hi guys, nice quarter. In terms of the new product wins at 40% of the growth in the second quarter, Kevin, that sort of would imply 6% to 7% type growth. Any reason why that wouldn't at minimum be the run rate for the second half of the year? Is some of the new wins rolling off?

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

Clearly, perhaps I'll take a stab at it, then turn it over to anyone else that would like to have some additional comments made. Clearly, we saw very good strong commercial performance in the first half of the year, and, of course, that will -- the benefits to the extent that it was first quarter our pipeline filled relative to these items that will bode well for the future but some of those new wins will be rolling off versus year-ago comparable. We don't comment on ultimately what that looks like going forward, but we're certainly happy with the performance in the first half and certainly we feel good about how we started the third quarter.

Mike Sison - *Keybanc - Analyst*

Okay. And then Nicolas, the recovery in Fine Fragrances have been pretty impressive. Are you at pre-recession levels now in terms of either your sales levels, and do you feel pretty good that the -- that there's been pretty good sell-through to the consumer? Maybe give us your thoughts on consumers buying more Fragrances now. Is that sort of what's partly driving the improvement?

Nicolas Mirzayantz - *International Flavors & Fragrances - Group President - Fragrances*

Hi, Mike. How are you? Regarding the market we know that it's right now mixed performance across all the regions was probably a strong performance in Europe and Latin America versus North America. We're not seeing the market growing at the level where we're growing at the moment, so as we were explaining, we were both enjoying the effect of restocking. Some easier comparables but also strong pipeline of new wins. So we feel that going forward, we're not going to be able to enjoy that as much restocking effect both at the customer and retailers, but we feel confident with the pipeline of new wins moving forward. And regarding your questions, we are back at the level prior to the crisis.

Mike Sison - *Keybanc - Analyst*

Okay. And then last one for you, Doug, granted, you've really only been around for, well, since March really in-depth here, but when you think about the long-term goals, any thoughts there? Is it conservative? Is there opportunities to better than those longer term? Just your thoughts on what the -- those longer term goals that were set sort of previously.

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Sure. And I think they're compelling goals as they sit now, Mike. I guess in the context of the current environment we've only touched upon while they are long term goals for this fiscal year, we would expect to beat those goals with the exception of the operating margin number, but sales and EPS we should beat them. I think the real answer to your question hinges upon the deliberations that the Management group will have with the Board late this year -- this calendar year, us surrounding the strategy work that's going on. It is such a comprehensive review that's being undertaken of the Company and its businesses, regions, customers, categories, and so on that we will come up with recommendations. Now, will the recommendations suggest a retention of the existing financial metrics, or raise them or lower them? All that is yet to be played. I realistically don't think of anything but equal or better are options and am confident, we can do that. As you go through a review that we have, it's shown many, many parts of the business are very successful. But as you probably expect in a cost review also identifies areas for improvement, and that is what we're investigating, and if those improvements can be delivered in a cost-effective manner for the shareholder, then that would suggest a revision to the goals, but that is premature at this point.

Mike Sison - *Keybanc - Analyst*

Great, thank you.

Operator

Your next question is from the line of Mark Astrachan with Stifel Nicolaus.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Hi, good morning everyone. Doug, just first off, following up on that last question on the strategic review, just curious your thought process on undertaking that meeting. Did you suspect there were some things that could be done better, some stones to overturn, so to speak, or sub optimal levels of operations in certain aspect of the business that you thought potentially could have been improved upon? Just give us a little bit of background, if you would, on why you decided to do that as you began your time with the Company.

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Sure. Well, I think the primary goal was really to establish a fundamental foundation of an operation in past lives and past companies that have done things similar really to get more than anecdotal information but a grounded fact base. Really, coming out of 2009, where lots of companies were de-stabilized, and while IFF was not de-stabilized compared to others, we certainly took a few flows. So I think it was very much also the will of the Board, that said, let's take an opportunity to understand where we are making money. There are concrete capital decisions that need to be made going forward, and putting our money where the best opportunities were warranted this review. So, yes, I didn't have any suspicions that things were really adrift. The Company is very strong. The Management base is very strong. I was thrilled to join the Company. But it is natural to assume there are opportunities, and the work not surprisingly is identifying some pockets of brilliance at the Company that we should maximize and some opportunities for improvement.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Okay, great. And then somewhat relatedly, the cash flows are definitely being generated at a better rate than a year ago. You're doing a good job of paying off the debt. Just curious about what your views are on the optimal capital structure, including potential uses of that cash beyond just buybacks and dividends and whether you would look to make some acquisitions, and if so what sort of criteria might you be looking at?

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

Good morning, Mark this is Kevin. I will jump in. I think that we've talked historically about our dividend payout ratio, and we're still sticking to those general levels that we've communicated in the past in terms of returning capital to shareholders. I think that pending our review on the strategy project, that will determine ultimately what prospectives we will have going forward as it relates to any potential change or continuation of the existing policies and beliefs that we have as it relates to those returning of cash to shareholders. I would say that clearly the past has indicated a willingness to return capital to shareholders, and certainly our cash flows suggest that there is an ability to do that, and I think the fact that the Board approved the dividend, even with the context of our strategic review going on, they knew and had comfort as it relates to the strong capabilities of the Company to generate cash and still be able to provide a dividend with that strong cash flow and potentially invest behind any new growth opportunity, whether they be internal or external.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Okay, great. Then just finally, on the operating margin, you alluded to the a little bit, Kevin, 18% is the longer term target out there. And clearly you're doing a good job of increasing the operating margin. It doesn't factor in any of the rationalization in Europe. Just curious, how you're thinking about those opportunities and target longer term.

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

I think it will be dependent, again, as Doug suggested, a little bit on our strategic review that we're in the midst of working on right now. I think that we've said that the 18% is in itself a good target to be going after, and that there is potential opportunities to even go beyond that but I would hesitate to suggest that we're going to change anything at this point in time until we get to a place where we're very clear on the investment that we may want to be making in terms of potential future growth opportunities. So I think we're making good progress. We believe that there's an ability to drive margin enhancement and support growth, and that's what we're going to continue to try and do in the interim.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Great. Thanks, everybody. Congrats on the nice quarter.

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Thank you.

Operator

Your next question is from the line of Mimi Neal with Sidoti & Company.

Mimi Noel - *Sidoti & Company - Analyst*

Good morning, it's actually Mimi Noel. Forgive me if you've already covered this, gentlemen, a few things this morning. Just would care for your insight on major consumer product manufacturers similarly pushing more for market share than they are for product innovation, at least in certain markets. How does that affect your business or how do you -- what is your perspective on that outlook?

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Our goal is to supply customers, whether it's innovation or ongoing formula, and that's what we're doing. Certainly we will always be leading our customers to a degree with the view to the benefits we get from our consumer insight group and pointing out opportunities for product innovation for those customers. So it's a collaborative approach, and certainly one of the things we will always be doing is considering the investment in that new product activity and innovation, and we work with our partners to look for profitable opportunities. Right now we have seen some cut-back from that and look for just ongoing evolution in the formula.

Mimi Noel - *Sidoti & Company - Analyst*

I would assume that the economics for innovation, more innovative products are more favorable than ongoing formula.

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

It can depend. Obviously innovation is something that we put our -- a lot of effort into. If the product is successful in the marketplace, the long-term margin can be good but they're not all successful.

Mimi Noel - *Sidoti & Company - Analyst*

That's all I have for the time being. Thank you very much.

Operator

(Operator Instructions) You have a follow-up the line of Jeff Zekauskas with JPMorgan.

Silke Kueck - *JPMorgan - Analyst*

Just a couple of housekeeping questions. What is the amount of sales and profit, if any, that you expect from the Redpoint licensing agreement? And can you clarify again what this five-year agreement is? Is it an exclusive agreement, or is it exclusive just in one area related to sweetness?

Hernan Vaisman - *International Flavors & Fragrances - Group President, Flavors*

At this point in time, we cannot precise say what will be the revenue stream that we have, your first question. The other one is exclusivity on certain Food and Beverage categories for the five years.

Silke Kueck - *JPMorgan - Analyst*

So it's unspecific Food and Beverage categories?

Hernan Vaisman - *International Flavors & Fragrances - Group President, Flavors*

Yes.

Silke Kueck - *JPMorgan - Analyst*

Can you comment on which one, or is it confidential?

Hernan Vaisman - *International Flavors & Fragrances - Group President, Flavors*

I prefer not to disclose this information.

Silke Kueck - *JPMorgan - Analyst*

Okay. Secondly what is the magnitude of the legal expenses in the quarter? And are those related to still to like the butter flavor litigation? I was wondering -- a really short update on it, as to how that it's going. Maybe how many pending cases there are at this point.

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

We don't really talk a lot or disclose the specificities associated with the variety of things that are currently in the works. But I would go back again, Silke and talk to the fact that in the quarter, I commented on that there was 250 basis points roughly of incremental costs that were incorporated into our results in RSA relative to abnormally high levels of costs. And certainly that number would be included in that figure so at this particular point in time, we're not going to disclose or talk further than that, but we believe that we've made provisions that are appropriate relative to any particular facts these we have at this point in time.

Silke Kueck - *JPMorgan - Analyst*

And last one again, housekeeping item, can you just clarify what the nature of the accounting restatements are? I think earlier in the year there were some restatements made to move some R&D tax credits from the tax line back into R&D, and now there are yet more restatements. What are the nature of these?

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

Effectively, there was a determination last year that it was appropriate to take some of these credits up into operating expenses. It's a pretty sizable number in the back half of 2009, and we commented that if we had treated that -- those credits similarly to the balance of 2009 it would have had a less impactful change in terms of the first half of 2009. So we're now comparing versus those kind of restated figures. It's not a material number in the second quarter. I'd have to go back and see exactly what it is, but it's not a material number in the second quarter of 2010. But it is effectively -- will potentially be a larger number in the second half because we had some big credits in the second half of 2009 which will not be duplicated to the same extent in the second half of 2010.

Silke Kueck - *JPMorgan - Analyst*

Are amortization expenses now rolled into SG&A expenses?

Michael DeVeau - *International Flavors & Fragrances - Mgr IR*

Silke, this is Michael. We just actually collapsed it in there just for presentation purposes, but consistent with previous years.

Silke Kueck - *JPMorgan - Analyst*

Okay. That's all I have. Thanks very much.

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

Thank you.

Operator

Your next question is from the line of Erik Sjogren with Morgan Stanley.

Erik Sjogren - *Morgan Stanley - Analyst*

Hello? Hi, this is Erik here from Morgan Stanley. Couple questions. The first is that you were -- many of your customers within Staples are talking about difficulties in raising prices, even though raw material costs are coming up. Is this something that you've been seeing in your discussions with them? Are they essential leaning on you perhaps for price relief as their own costs start to come up? Secondly, just a general comment on the [Brief] pipeline, how it's been developing. Obviously you've had very good win rate, but in general are the Briefs still coming through at the same rate and the scale of the Briefs, is it similar? Then finally, when you review the Flavors division, you mentioned Beverages as a stand-out area. Could you give us a bit more color on what has been driving that? Is there some specific part within Beverages also, we've had a very warm summer here in Europe. Is there a seasonal impact here in the second quarter? Thanks.

Nicolas Mirzayantz - *International Flavors & Fragrances - Group President - Fragrances*

Hi, Eric. Nicolas. I'll answer the second question regarding the pipeline of new projects. We're seeing still solid foundation for -- and strong pipeline of new production coming in. So we're not seeing any slowdown that in respect, if not actually an increase.

Hernan Vaisman - *International Flavors & Fragrances - Group President, Flavors*

Hi Erik, How are you doing? Following the first question, it's that same, Fragrances we really see very strong pipeline. We haven't seen any kind of reduction. Regarding your question in Beverage, these new wins, of course we've got some. Restocking element, but we have very good wins, strong wins in Europe, and other regions, basically because we have improved our portfolio and given the right value proposition to the customer.

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

On the pricing comment, and I'll invite Nicholas and Hernan, there is always an ongoing degree of tension with that in quotation marks in negotiations, the customer is looking for the best possible price and we have to deliver that. I would come back to innovation comment that -- from the context of they continue to look for innovation, and if we can bring superior innovation in the health and wellness areas, in particular there are opportunities for pricing improvements, but the flip side is also the ongoing negotiations that we have with our suppliers and looking for efficiencies and gains as well. So we are a part of that value chain and get -- look for as many efficiencies as we can get, even as customers ask us for some.

Erik Sjogren - *Morgan Stanley - Analyst*

Great, thank you very much for that.

Operator

Your next question is from the line of Richard O'Reilly with Standard & Poor's.

Richard O'Reilly - *Standard & Poor's - Analyst*

Good morning, gentlemen. Thank you. I want to get back to the new business contribution. The 40%. I think this is a number that you have just started to disclose, at least that I can see. How does the rate of 40%, how does that compare with a more traditional historical level, because it just strikes me as a very large percentage.

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

Richard this is Kevin. We have reported this number in the past, and as both Hernan and Nicolas have suggested, it's a strong level of performance.

Richard O'Reilly - *Standard & Poor's - Analyst*

Okay, fine. This is a simpler question. I'm not a consumer products analyst, and I'm just wondering, what categories are growing? What can I see in the supermarket or in a retail store that would give me an idea where the business is coming from? I know you don't talk about customers, per se, but I was just wondering what categories you could point to.

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

Look, I think, Richard, if you were to take a look at the recently reported numbers of our customers, you would see in general that there's been some up tick in volume versus kind of prior year period, as they have attempted to, let's say, alter their mix of growth. It was very largely price driven two, three years ago, and they're focused now on trying to drive a little bit more value and volume into their portfolio. So I would say in general there is an up tick in volume from our customers across the board. I don't know that we would comment specifically on specific categories, but I think that that's a general rule that you can look at and get a perspective on how that's impacting certainly IFF.

Richard O'Reilly - *Standard & Poor's - Analyst*

Okay, thank you then.

Operator

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

John Roberts - *Buckingham Research - Analyst*

Good morning, guys. Can you hear me okay?

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Just fine.

John Roberts - *Buckingham Research - Analyst*

It may be just my perception, but it seems like governments are stepping up their attack on calories and salt, and you've got initiatives to try to put taxes on high caloric beverages and more labeling requirements coming down around salt. Do you think the amount of Briefs in the food and Beverage area are going accelerate as your customers try to formulate to position their portfolios around some of these? It seems like it's an acceleration or step change -- for a long time. You see it in the papers more these days.

Nicolas Mirzayantz - *International Flavors & Fragrances - Group President - Fragrances*

Yes, definitely we see an up side in this trend, and one Doug mentioned about this agreement we have is aiming to provide ourselves with a better portfolio to capture this market that is really growing and will be growing faster. I could say that the big bulk of our efforts in R&D and creations -- are addressing these issues, how to replace sugar, how to reduce salt in all the -- and customer products.

John Roberts - *Buckingham Research - Analyst*

I think if you strip out restocking effect, the Food and Beverage area has outperformed the Fragrance area for a little while now, and I'm wondering whether that's sustainable. We've ought to think about Food and Beverage which I think is maybe historically been more stodgy and so forth, as possibly a more dynamic area in the next couple years?

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

I think they're both, frankly, still remain very attractive. I think your point on Flavors over the recent period outstripping Fragrances is bona fide, and some of that is obviously the difficulties of year ago in the more discretionary Fragrance category, Fine in particular. But as we look at the world, and look at the world where our customers are going, both innovation and opportunities and mature and developed markets, but particularly the emerging markets and more and more of the world wanting to get into the products provided by the customers that we serve and hence we are part of that value chain, we still see both businesses as very attractive. That's being further cemented as we go through our strategic review on the future outlook with fundamentally both products provided in Fragrances, Fine and Functionally, and Foods and Flavors look to be very attractive markets for us.

John Roberts - *Buckingham Research - Analyst*

Doug, you're like a parent that's asked which child they like better.

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

With four children I have to be very good at that.

John Roberts - *Buckingham Research - Analyst*

Okay, thanks.

Operator

You have a follow-up from the line of Mimi Noel with Sidoti & Company.

Mimi Noel - *Sidoti & Company - Analyst*

Thank you. Just one more quick question, Kevin and Doug. If you wouldn't mind expounding a little bit on your thoughts on your supply chain right now. Clearly your staff rose to the occasion, but what sort of constraints do you see beyond just IFF's internals?

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Help me understand the last part of that question a little bit more.

Mimi Noel - *Sidoti & Company - Analyst*

Sure, sure what sort of constraints do you see beyond -- or in looking at your supply chain what are some external pressures that you've had to offset?

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

I think one thing that certainly has been a challenge in the first half is access to materials. When you're growing at kind of levels that we've had, the supply chain organization did a really great job in ensuring that we had access to materials. And I think that that's a tribute to the flexibility and dynamic nature of this Company, to be able to react very quickly to ensure that we were able to continue to provide the service levels to our customers. So I think that's been one element. I think longer term we have to make sure that we have the capacities and the ability to satisfy what we consider to be some growth opportunities, and certainly those growth opportunities in the emerging markets.

Mimi Noel - *Sidoti & Company - Analyst*

Are you seeing any areas of cost inflation in your supply chain? I know you mentioned oil by way of example but do you have anything more concrete?

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

No, we'll not talk any more details than that. As you know, Mimi, we have a very, very disperse set of materials that we use in the manufacturing of our portfolio of product to the customers, and so I guess there's always pluses and minuses within that, but because it is so dispersant, it really is -- I wouldn't be able to tell you specifically, we'll focus on this and that gives you an indication. I would say that in general as suggested we continue to believe that we'll see some reductions over the balance of the year, not at the rate that we've seen in the first half, perhaps, but we'll end up still down for the year in 2010.

Mimi Noel - *Sidoti & Company - Analyst*

I do have one or two more residual questions. When you look at that 18% operating margin target, is the time frame, given the progress that you've made, henceforth is that time frame condensed at all, given the first half progress, or what is the legacy time horizon for that 18% target?

Kevin Berryman - *International Flavors & Fragrances - EVP, CFO*

I would say, Mimi, that a lot of that is dependent upon the work that we're doing right now as it relates to our strategies. I do believe that we have the ability to enhance our margins longer term, and the timing associated with that will be determined to some extent by any investments that we want to consider. So clearly, as Doug suggested, that's business as usual as right now we're continuing to drive for margin enhancement, then more to come as it relates to any new insights that will be gained relative to our strategic review.

Mimi Noel - *Sidoti & Company - Analyst*

And the results of the strategic review will be available to investors at year end, or early 2011? When do you think we might have the insight on that?

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

I think the perspectives that we'd be prepared to share will be available towards the end of the year, but I would just reiterate that we'll be prepared to share. It's very significant undertaking with the Board which while we're partway into the process, there are a number of what-ifs scenarios that could emerge, but to build on something that Kevin just said about the margin enhancement, there will be good discussions with the Board about propensity to invest significantly in future growth, and while we may know that internally, we wouldn't be able to, nor would we want to telegraph that externally. I expect there will be parts that we will be able to share with you of things, hopefully the clever things that we've uncovered and can do, but I think I'm foreshadowing that it won't be full disclosure.

Mimi Noel - *Sidoti & Company - Analyst*

Sure, okay. Can you say right now you're comfortable with the assumption of sales growth in the second half of the year, organic -- excuse me, local currency sales growth in the second half, that's an achievable objective?

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

The forecast that we have internally I think that is a fair assumption. I would say at the outset that it's looking towards the extreme tail end of the year, it gets a little murkier, but looking into -- we said the quarter started well and to the degree that's part of the foundation of for our forecast, we feel good about in Q2.

Mimi Noel - *Sidoti & Company - Analyst*

Okay, I follow. Thank you very much for the extra information.

Operator

There nor further questions at this time.

Doug Tough - *International Flavors & Fragrances - Chairman, CEO*

Thank you all very much for participating today.

Operator

Thank you all for joining today's conference call. You may now disconnect.