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IFF - Q3 2016 International Flavors & Fragrances Inc Earnings Call

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PRESENTATION

Operator

At this time, I would like to welcome everyone to the International Flavors & Fragrances third-quarter 2016 earnings conference call.(Operator Instructions)

I would now like to introduce Michael DeVeau, Vice President Global Corporate Communications and Investor Relations. You may begin.

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

Thank you. Good morning, good afternoon or good evening, everyone. Welcome to IFF's third-quarter 2016 conference call. Yesterday evening, we distributed a press release announcing our filings. A copy of the release can be found on our website at IR.IFF.com. Please note that this call is recorded 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 will be making forward-looking statements about the Company's performance, particularly with regard to the outlook for the fourth-quarter and full-year 2016. 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 statements and risk factors contained in our 10-K filed on March 1 2016 and our press release that we filed yesterday.

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

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 and CEO*

Thank you, Michael. As usual, we would like to start with an executive overview of our third-quarter and year-to-date performance. Then I will provide an update on the progress we are making in terms of our long-term vision 2020 strategy. Once finished, Rich will review our financial results in greater detail, including specifics on each business unit as well as our cash flow statement and outlook for the remainder of the year. Then I will provide some concluding remarks, and we will finish by taking any questions that you may have.

In the third quarter, currency neutral sales through 3%, led by an improved performance in flavors, plus approximately one percentage point related to the acquisition of IFF Lucas Meyer Cosmetics. Our top-line performance continued to be driven by new wins across both business units along with increased volumes in fragrance ingredients.

On the currency-neutral operating profit perspective, we expected quarter three performance to be muted, given the timing of planned investments, yet results came in softer than expected. This is largely attributed to lower-than-expected gross margin performance, which we'll provide more details in a moment.

As a result, currency-neutral adjusted EPS in quarter three was challenged despite the benefits from lower year-over-year shares outstanding due to our share repurchase program and a more favorable effective tax rate.

On year-to-date basis, currency-neutral sales growth for the first nine months of 2016 improved 4%, with 4% growth in flavors and 5% growth in fragrances. Currency-neutral adjusted operating profit grew 3%, driven by sales growth, benefits of our productivity initiatives and the contribution from acquisitions.

It should be noted that this is inclusive of approximately 3 percentage points of planned strategic investments as well as litigation and compliance-related costs made over the course of 2016. A portion of this investment is intended to help drive improved productivity and greater P&L leverage in the future. This, combined with lower shares outstanding and a more favorable effective tax rate, had a positive effect on our currency-neutral adjusted EPS, which increased 5% in the first nine months of 2016.

Reviewing our progress against our Vision 2020 ambition, we continue to achieve strong results in the key areas that we've identified as strategic priorities for us: encapsulation, modulation, North America, Africa, and the Middle East to name a few.

From innovating first perspective in flavors, sales of our sweetness and savory modulation portfolio continued its trend of strong double-digit growth, currency-neutral growth across all categories. In fragrances, encapsulation-related sales in personal wash and home care improved strong double digits in a currency-neutral basis, demonstrating that our technology is starting to gain traction in areas outside of fabric care.

In the third quarter, we also launched four new flavor molecules in the key tonalities of these of citrus, onion and garlic to help all flavors continue to build consumer-preferred products that perform in the marketplace.

In fragrances, building on our legacy of pioneering first, one of our Vision 2020 goals is to launch more new captive molecules to give our perfumers a competitive edge when creating the next great fragrance.

Tracking this initiative, we have recently commercialized a new captive fragrance ingredient called Saffiano to further drive differentiation. This particular fragrance ingredient is a strong, rich natural leather with powdery-soft sweet quality providing a unique, modern twist and is very additive to any fragrance creations. It enhances strengths and increases the facets and fragrance accords by providing a very clean, natural effect.

The combination of the two molecules we have released so far this year plus the two we expect to commercialize in the fourth quarter puts us on track to double our annual fragrance molecule output average from two per year to four per year. In addition to this expansion, we have also just adjusted our commercial fragrance ingredient strategy to release these types of captive molecules to the external market sooner to accelerate value creation.

In the areas where we are targeting a market leadership position, our growth has accelerated. Our strong growth momentum in the Middle East and Africa continued in the third quarter as currency-neutral sales improved strong double digits, with both businesses achieving very strong growth. North America fragrance -- we saw 6% increase for the third quarter, driven primarily by strong double-digit growth in fabric care. This was led by our encapsulation platform as we continued to leverage this technology to gain market share.

Another strategic area for us is home care, with low single digits on a currency-neutral base led by double-digit growth in greater Asia.

We also continued to position ourselves to be our customers' partner of choice and go-to supplier. Our ongoing commitment to provide our customers with in-depth local consumer understanding, superior innovation, outstanding service and the highest quality product allowed us to continue to capture the growth of both local and faster-growing regional accounts, with regionals outpacing global accounts.

This should strengthen as our acquisition of Ottens Flavors and, more recently, David Michael and Fragrance Resources, the one we announced our intention to purchase last week, are all very strong from their regional customer bases.

We are also collaborating with Delos and Mayo Clinic to be a part of their well-being lab, which is a new research facility dedicated to understanding the interaction between health and well-being and indoor environments -- so, human-centered research. This world-class living leverages an expense upon the principles of the well-building standard, which focuses on seven concepts relevant to indoor health: air, water, nourishment, light, fitness, comfort and (inaudible). We are excited about the opportunity to leverage our expertise in scent to help improve the lives of individuals.

In the third quarter, we also became the first flavor and fragrance company to join the World Economic Forum. As pioneers of the senses for more than 127 years, we embraced this unique opportunity to exchange ideas with other leading organizations who are interested in making positive, lasting changes in society.

This collaboration with the forum alliance was IFF Vision 2020 strategy, which underscores how we are as a Company and businesses in general can innovate in the area of artistry, science, technology and sustainability to produce positive results for both business and society.

I'm also proud to be elected to the World Business Council for Sustainable Development executive committee. The WBCSD is a CEO-led organization of forward-thinking companies that galvanizes the global business community to create a sustainable future for business society and the environment. I'm extremely excited to represent IFF and about our journey as an organization to help leave the world a better place for generations to come.

We continued our trend of strengthening and expanding our portfolio by accelerating our efforts in M&A, with the addition of approximately $160 million in expected annualized sales from the acquisition of David Michael and Fragrance Resources, both of which complement our strategic vision well. I will speak in more detail about each of these acquisitions in a moment.

I'm happy to report that IFF Lucas Meyer Cosmetics continues to perform well, achieving double-digit growth on a standalone basis. We believe their performance is a good indication that we are putting our capital towards long-term, value-creating opportunities.

Turning to our more recent acquisition announcements, David Michael is a privately held flavors company headquartered in Philadelphia. The company is well-known in the industry for its vanilla expertise, strength in berry and beverage categories, and relationships with dynamic, faster-growing middle-market customers.

David Michael complements our other flavors acquisitions from last year by strengthening our ability to serve the faster-growing midmarket customers in North America and solidifies our strong number one position in flavors North America, a strategic priority for us.

The deal, which closed on October 7, expects to add approximately $85 million of sales in 2017, and expected to be EPS-accretive in year one and economic profit breakeven between years three and year five. This bolt-on acquisition is another important milestone in IFF's Vision 2020, helping us win where we compete in the world's largest flavor market as we look to further accelerate growth.

Late last week, we also entered into an agreement to acquire Fragrance Resources, a privately held, family-owned fragrance company who for nearly 30 years has distinguished itself with exceptional creative talents and quality service to faster-growing regional customers. This highly complementary bolt-on acquisition further will increase our penetration in specialty fragrances, a faster-growing subcategory within fine fragrances, and is expected to strengthen our market share position with a regional customer base within the key markets of North America and Germany.

Fragrance Resources is expected to add about $75 million of sales in 2017 and will also be EPS-accretive in year one and economic profit-breakeven between years three and year five. Right now, we expect an early 2017 close, and we look forward to welcoming Fragrance Resources to IFF.

The combination of both acquisitions is expected to contribute approximately 4.5 percentage points to our currency-neutral sales growth in 2017. This, plus expected cost synergy benefits, will lead to greater financial performance in the years to come.

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

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

Thank you, Andreas. And good morning and good afternoon to everyone on the call. Building on Andreas' commentary, sales growth on a currency-neutral basis for Q3 came in as expected, growing 3%, with 3% growth in flavors and 2% growth in fragrances.

On a consolidated basis, our top-line growth benefited from approximately 1 percentage point related to the contribution of our Lucas Meyer's cosmetics acquisition. On an organic basis, we grew 2% on a currency-neutral basis, driven by new wins across both businesses.

I want to provide you with greater insight with respect to our performance, including foreign exchange-related pricing for Q3. As a reminder, our industry indexes the majority of its pricing in emerging markets to movements in foreign exchange rates.

For example, in Brazil, while actual invoicing is done in Brazilian real, the invoice amount is indexed back to hard currencies such as the euro or the US dollar. On a predetermined basis, prices are adjusted up or down to reflect the underlying movements of currency and the product profile.

When reporting, we exclude the indexation effect on local currency invoicing from our currency-neutral sales growth calculation. This is different from our competition. In Q3, adjusting our currency-neutral sales growth calculation to a basis similar to how our competition reports, our currency-neutral sales growth would have increased to approximately 3% organically and 4% inclusive of the acquisition of IFF's Lucas Meyer's cosmetics. On a tier basis, to factor in the year-ago performance, organic currency-neutral sales would have increased to an average of 4.5%, which is ahead of our largest competitor by approximately 150 basis points.

From a profitability perspective, currency-neutral adjusted operating profit was down 4% year over year, principally due to year-over-year decline in gross margin. And I'll walk you through that in greater detail in a moment.

We benefited from a lower year-over-year shares outstanding and a more favorable tax rate that helped offset the impact of our operating performance on a currency-adjusted EPS basis.

Looking at our Q3 currency-neutral operating profit results, I want to provide more clarity on our performance drivers year over year. In the second bar, you see the contribution of our cost and productivity initiatives. Due to likes of formula optimization, indirect procurement savings and manufacturing efficiencies in both compounds businesses, we delivered approximately 6-percentage-point benefit year over year to overall profitability. In the third bar, you can see that growth added approximately 5% to profitability.

From a headwind perspective, there are several items that I need to elaborate on. In the fourth bar, RSA expenses represented approximately a 5-percentage-point drag on operating profit. It should be noted that this includes approximately 3 percentage points related to planned investments that we mentioned earlier in the year and another one percentage point in compliance- and litigation-related costs. The strategic investments, while they challenge profitability in the short term, are expected to yield PNR leverage in the years to come.

The greatest gap to our previous guidance came in the form of weaker sales mix. Beverages, our highest margin category in flavors, have limited growth in the quarter, while savory, a less profitable category, performed very well, growing high single digits. On the fragrance side, we experienced a similar dynamic, with fine fragrances' strong margin category declining year over year, while we experienced growth for the first time in approximately two years in our fragrance ingredient business, which is a less profitable category. Net net, this led to an unfavorable sales mix which represented a 3% drag to operating profit.

In addition, we were also pressured by year-over-year manufacturing performance principally related to manufacturing yields in our fragrance ingredient manufacturing network.

Rounding out our performance, price and input costs and other miscellaneous items, including the year-over change in incentive compensation, were the remaining headwinds.

Turning to our business unit performance for the third quarter, flavors' currency-neutral sales increased 3%, driven by mid-single-digit growth in savory, dairy and sweet.

From a regional perspective, growth was led by high single-digit increases in Latin America and mid-single-digit growth in greater Asia and Europe, Africa and the Middle East.

North American results were challenged, reflecting low single-digit growth in savory and sweet that was offset by softness in beverage.

Europe, Africa and Middle East increased 5% on a currency-neutral group basis, as growth was led by new win performance, particularly in savory and sweet. Africa and the Middle East continued its impressive growth trend, improving strong double-digits in the current third quarter. Greater Asia posted 5% currency-neutral growth, led by strong growth in India, Asia and Indonesia -- and China, which returned to growth after several quarters of decline, partly due to the manufacturing order issues that we saw in early 2015. We're happy to see that the business is stabilizing and returning to growth as the order issue is behind us.

On a category basis within greater Asia, we achieved double-digit growth in both beverage and dairy. Growth in Latin America rebounded, improving 7% on a currency-neutral basis, led by strong double-digit growth in both Brazil and Mexico.

Flavor's currency-neutral segment profit was challenged as volume growth and the benefits from productivity initiatives were offset by weaker mix, unfavorable price to input costs and increases in RSA.

Fragrances' currency-neutral sales improved 2%, including approximately one percentage point associated with the acquisition of IFF Lucas Meyer Cosmetics. Growth was led by high single-digit growth in ingredients and low single-digit growth in consumer fragrances.

From a category perspective, fine fragrances was challenged. On a currency-neutral basis, as strong double-digit growth in greater Asia and low single-digit growth in North America was more than offset by softness in Latin America and Western Europe.

It should be noted that we believe that a part of our softness in fine fragrance can be attributed to a large fine fragrance customer who is also going through a portfolio transition via divestiture.

Consumer fragrances grew 1% on a currency-neutral basis, led by mid-single-digit growth in fabric care and personal wash. On a geographic basis, in consumer fragrances growth was led by a high single-digit increase in greater Asia and mid-single-digit growth in North America. Fragrance ingredient sales were up 8% on a currency-neutral basis, driven by low single-digit growth on an organic basis and the contribution of sales related to IFF Lucas Meyer Cosmetics. From a profit perspective, fragrances' currency-neutral sales profit declined as volume growth and the benefits of cost and productivity were offset by weaker mix, unfavorable price and input costs, manufacturing performances and increases in RSA.

From a cash flow perspective, operating cash flow improved 12% versus the same period in 2015. Our operating cash flow was 14% of sales, up from 12.8% in the first nine months of 2015.

This change was driven by our poor working capital levels improving versus year-ago period, principally driven by improvements in accounts receivable.

In terms of capital deployment, capital expenditures through the first nine months totaled $70 million, and we are on track to spend approximately 5% of sales in 2016. As previously noted, this increase will be principally driven by capacity projects in greater Asia and investments in technology expansions.

Switching gears to cash returned to shareholders, during the first nine months of 2016 we spent approximately $134 million on dividends and $94 million on share repurchases. This puts us on target to deliver on our commitment to return 50% to 60% of adjusted net income to our shareholders.

As we finish up 2016, we expect business trends to improve sequentially in the fourth quarter. We expect stronger currency-neutral top-line growth in Q4 versus Q3, driven by improvements in both flavors and fragrances and the benefits of our acquisition of David Michael. For modeling purposes, we have assumed that David Michael added about 200 basis points to currency-neutral sales growth in Q4 while providing them with benefits on an operating profit basis given the increase in purchase price accounting impact.

From a currency-neutral operating profit basis, growth is expected to strengthen in the fourth quarter. And while we do expect pressure on gross margins to continue given the sales mix dynamics we discussed earlier, we believe that improving volume trends and the benefits associated with cost and productivity initiatives will drive operating profit growth year over year. This compares as we compare to our largest year-over-year core LEED that the incentive comp during the fourth quarter last year. The combination of this currency-neutral operating profit performance plus lower shares outstanding and some benefits in our effective tax rate is expected to lead growth and currency-neutral EPS also.

Upon entering 2016, we expected challenging conditions given the high level of economic uncertainty and a more cautious buying outlook of consumer packaged-goods companies. As evident in today's marketplace, this is indeed the case, as volume consumption remains challenged across many end-market categories, and economic volatility and visibility in key markets around the world remains challenging. We acknowledge that we are slightly lowering the previous guidance we provided earlier this year. Nevertheless, the viability of our business remains strong, and we expect to deliver growth across all of our key financial metrics on a currency-neutral basis.

For the full year, we see currency-neutral sales improving 4% to 5% versus 2015, with broad-based contributions from organic and inorganic business. Currency-neutral operating profit is expected to grow 3.5% to 4.5% in large part due to the benefits of cost and productivity improvements, increased volumes and the benefits of acquisitions.

It should be noted inclusive in our guidance is approximately 3 percentage points of litigation and compliance-related costs as well as planned strategic investments made over the course of 2016.

As I mentioned earlier, these investments are intended to help drive improved productivity and greater P&L leverage in the years to come. From a currency-neutral adjusted EPS perspective, we expect a modestly lower effective tax rate and the continuation of a share repurchase program to lead to 5% to 6% improvement on an EPS basis.

In terms of foreign exchange, we have tweaked the impact of currency on our guidance, as it is slightly more favorable. On a sales basis, we expect currency to impact results by approximately 1.5 percentage points; if we are up in adjusted operating profit and EPS, we expect a 2-percentage-point impact.

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

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

Thank you, Rich. In summary, despite the challenging global operating environment, our year-to-date results are solid with 4% growth in flavors and 5% growth in fragrances.

Progressing in quarter four, we expect business trends to improve sequentially versus quarter three as all of our key financial metrics return to growth on our currency-neutral basis. Longer-term, we continue to be focused on the execution of Vision 2020, which is geared towards accelerating our growth, increasing differentiation and driving cost efficiency, which in turn should lead to sustainable profitable growth.

Our R&D pipeline is the strongest it has been. We are winning in key markets categories that we have identified as strategic and we are executing our M&A agenda, all which will lead to greater value creation for our shareholders.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Mark Astrachan, Stifel Nicolaus.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Rich, productivity outpaced reinvestment in the quarter, I think, a little bit more favorable to than expectations going in the beginning of the year. So I guess I'm curious your thoughts from here about anticipated product re-initiatives and reinvestment. As I recall, in June last year you had talked about anticipation of reinvestment being net neutral versus productivity initiatives. Now it's obviously more favorable. So I guess how should we think about that dynamic in the fourth quarter but also into 2017 and beyond? And what level of productivity initiatives are now required to grow even in line with those long-term targets?

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

Okay. Thanks, Mark. Clearly, as I talked about last year and the current situation, productivity gains are clearly a key component of our financial algorithm. When we do better, we have more ability to reinvest. When we don't, we've got to adjust our spending and control our costs.

The combination of volume growth and productivity gains are really what drives the foundation of our P&L leverage. And we've got to manage all three of those dynamics: volume growth, productivity, and how much we reinvest and invest in the business.

In the current environment, it's -- as you've seen, it's challenged. Growth is below our historical trends and below our long-term financial guidance. And as a result, we've had to adjust how we allocate those resources.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Got it. Okay. And just related to that last point -- and I'll preface it by saying macros have clearly become a bit worse probably than anticipated last June. But I'm curious how you think about the Company's ability to achieve their revised long-term targets that you set out for sales EBIT and EPS last June, given since then I don't think the numbers have really hit those targets, certainly not on an average basis. So are those metrics still reasonable? Or, considering the market conditions, do they need to be reassessed, particularly sales growth given it's important to driving the other two?

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

Maybe Mark -- it's Andreas -- I take it. We believe that it's reasonable on a long term. I believe what's important for us always that we can't manage our business quarter to quarter because it's a long-term business here as well. And what we are doing actually to make sure that we hit our long-term targets -- first of all, we believe that we are capable to produce solid top-line results given our focus on innovation. Our pipeline, as I said, is actually very strong. It was never as strong as it is right now. Emerging markets -- we had a dip in the last, let's say, 18 months. We believe that the emerging markets will eventually come back. Also, the currency situation here was challenging for us. And we are diversifying our portfolio as well.

In terms of the mix, I believe we have the focus right now on the mix improvement, which we have done in the past. The fixed-cost leverage will help with the productivity initiatives. And here, I think what's important -- and maybe Rich can talk about it -- some initiatives are the initiatives we are doing always on manufacturing. But with DDB, we have now, let's say, a new lever which we are pulling. But Rich, you might comment on that one.

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

Sure. Thanks, Andreas. For me -- as Andreas mentioned earlier, we've got to look at both the short-term profitability but also make sure we protect the long-term growth prospects and strategy of the business.

And, look, clearly we are undelivered under-delivering in 2016 versus our long-term targets. We're not going to be able to make that up overnight. And we're still in the early stages -- or still in the stages of planning for next year. But I think, as Andreas talked about, focusing on innovation, those are things that drive expansion of our gross margins as with the productivity gains.

ZBB -- that's part of the strategic investments we made during this year. We're starting to embed that in the organization, and we'll start to get benefits. We've seen some of the benefits this year, but I think it will continue to ramp up next year into the future.

I think we've got to look at everything we do and look at our business model on a broad basis. How do we operate and how do we leverage our capabilities across the business? How do we continue to drive process efficiency at a functional level? And all those things will enable us to manage our cost structure and provide the balance between profitability and our ability to reinvest and grow the business on a long-term basis.

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

And if I might add, one of our pillars in this strategy is actually our M&A ambition. And if we assume for a moment that we close on the Fragrance Resources, we have done actually four deals in last 15 months, which will roughly add just right now, without the growth in the future, $264 million in sales. And they are actually quality assets which will help us in terms of mix and in terms of diversifying our customer base as well. So that's something, plus the synergies which might come out of these acquisitions which will help us to achieve our goals. I think all of that taken together, we believe that we can make that.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Great. Thank you.

Operator

Lauren Lieberman, Barclays.

Lauren Lieberman - *Barclays Capital - Analyst*

I want to go first on the North America flavors. That business came in a bit lighter than I expected. And I remember there being some business that was expected to be commercialized in the second half -- a big win. So just wondering if that happened, if there was another delay or what the situation is there. Thanks.

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

I would say it's just a challenging environment in North America for us at the moment. I think that's what I would comment. And that makes it even more important for us that with the two acquisitions, David Michael and Ottens -- that we bring it together as our platform for the midmarket because that's where we see the growth. And that's our main objective right now: to become the leader for the midmarket and the smaller customers. And I think when that's happening you will see growth as well now, because now with these two companies in our portfolio we have enough critical mass to move a big market like North America for us.

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

Lauren, from a category standpoint I'd say beverage was down. And on the other side, savory and sweet were up slightly but not enough to offset the weakness that we saw in beverage.

Lauren Lieberman - *Barclays Capital - Analyst*

Okay. Great. And then also I was just struck both by the comments in the release in the earnings bridge on the difference between input costs and pricing. And then I think in the Q you talked about a fairly benign input cost environment. So can you just help me triangulate those two, the (inaudible)?

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

Sure. It's a combination of factors, Lauren. I think we saw price input pressures in both businesses on the flavor side. It's really driven by the price increases on naturals and the inventory levels that we have where we are experiencing the impact of those very, very quickly. Vanilla is certainly one of the key aspects that we're seeing that pressure. As Andreas talked about, the acquisition of David Michael will help us on that aspect.

On the fragrance side, it's really a couple things. One, from a pricing standpoint it's been more about pricing pressure from a customer standpoint. And then the second piece is really related to our ingredients business, where we've wanted to address the declines in that business. And we've gone and looked at our go-to-market strategy, and we want to protect our market share more aggressively, and so we've had to adjust pricing accordingly.

On the compound side, it's more about pricing pressure from the customers and what's necessary to defend the business that we have today.

Lauren Lieberman - *Barclays Capital - Analyst*

Okay. So as I look forward into next year, that would suggest more price-constrained marketplace than maybe we would have expected six, nine, 12, 24 months ago. Is that reasonable?

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

Lauren, I don't want to go into too much detail. We'll have more clarity in February. But I'd say that what we're seeing today and what we expect today: that pricing will be -- pricing input costs will be up next year. Not huge amounts like we've seen in the past, but it is going to be up. And that's principally going to be driven by naturals in both businesses as well as some of the downstream effects of oil-related derivatives as we've gone from -- as you know, we've gone from $30, $40 a barrel up to $50 a barrel.

Lauren Lieberman - *Barclays Capital - Analyst*

Right. Okay. But at the same time, your ability to price to recover some of that is more constrained?

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

Certainly on the fragrance side, yes.

Lauren Lieberman - *Barclays Capital - Analyst*

Okay. And then would the thought be to accelerate productivity to try to make up that gap? Because it definitely sounds like the fragrance business probably a little bit less stability to recover cost than the naturals exposure.

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

I think, as I mentioned earlier on Mark's question, we're going to have to look at productivity and what we can do from a productivity standpoint at the manufacturing level. We're going to have to look at what we can do to simplify and streamline the organization and the overhead levels. And we're going to look towards, as I mentioned earlier, benefits associated with embedding ZBB-type principles across the organization. And all three of those things are going to enable us to manage the -- as I said earlier, manage the dynamic between profitability growth, our expectations and our ability to invest in the business long-term.

Lauren Lieberman - *Barclays Capital - Analyst*

Okay. Thank you.

Operator

Mike Sison, KeyBanc.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Congrats on the new role there, Rich. When I take a look at the third-quarter currency sales growth outlook relative to what you said in the second quarter, it's actually up, so it's a little bit better. And then you talked about some of the headwinds you faced. And your currency-neutral operating profit growth is lower than you said in the second quarter. How long do you think it will take to sort of flush through some of these issues? And I would imagine you think that the leverage on operating profit growth should be better than sales growth; right?

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

As I said in my remarks earlier for Q4, operating profit leverage in Q4 will be better than top line. I think that that's despite the incentive comp reset that I mentioned earlier. I think short-, medium-term, we still expect to see pressures on sales mix. Fine fragrance is still going to be pressured. And I think, you think about early next year -- Q1 was the strongest quarter we had for fine, and so that's going to -- I think it's going to be very challenging as we start next year. So as we look into next year, we're going to be -- we're planning and we're acting on a conservative basis. I don't think that we're sitting here saying that there's going to be a robust environment or a robust recovery next year.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Right. Okay. And then when I think about acquisitions, you mentioned you are going to add about $150 million in sales growth for next year. It's about 5%. Does that -- or should that lever to a similar amount of EPS growth next year?

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

Probably it's a bit early -- this is Andreas taking it -- because we will, let's say, integrate these companies fully next year. So, David Michael -- we have closed the deal early October, so we need some time to make sure that we integrate it well into our platform here. It's actually turning organic in the fourth quarter next year. And the other deal with Fragrance Resources, we will hopefully close early 2017. So it will take some time to extract -- let's say, to integrate it very well into our network as well. So it will help us quite significantly on the top-line growth, as we just outlined. But Rich might comment on the cost side.

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

Mike, from a profitability standpoint, EPS -- I think as you saw in our commentary, we expect to be EPS-accretive. But it's not going to be anywhere near that impact from a profit standpoint because we're going to have a step up in basis. And so, as we saw with Lucas Meyer's, as we saw with the Ottens, particularly early on it's not going to have much of an impact at all on operating profit, depending upon what comes out of the evaluation work.

On a cash basis, sort of an EBITDA basis, it certainly will be more positive. And then over time, as Andreas alluded to, as we're able to integrate the two acquisitions and drive the business rationale and the synergies, we'll able to start to get more and more of an impact on an operating profit basis.

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

And as we always said, we started last year with our first two acquisitions. We haven't done too many over the last 15 years. But now we are getting a little bit more skilled, also integrating these assets into our network -- and as fast as we can do it, as fast as we can produce results here.

So we are actually pretty well on track with that, and I'm very satisfied with all the progress we are making on the M&A front here because that gives us another, let's say, critical mass we can basically play with.

Mike Sison - *KeyBanc Capital Markets - Analyst*

Great. Thank you.

Operator

John Roberts, UBS.

John Roberts - *UBS - Analyst*

Could you actually elaborate a little bit more on the fragrance ingredients strength? It was up double-digit in most areas. And a little bit more detail on the North American beverage weakness and what's behind that?

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

John, first of all, good morning. It's Andreas. On the fragrance ingredients, it's quite a remarkable turnaround we are seeing here, and it's basically led to a couple of factors. Let's start with the not-so-exciting one -- it's technically because we are cycling through with one of our big customers we lost before. So the comparison is a bit better for us.

But also, the strategy is revamped now. And Nicholas and his team have done a great job to look into the business, into our customers -- made a good, let's say, approach in terms of target the right customers. And started also selling of our more captive molecules earlier, which is actually bringing us a greater value creation already upfront. We have waited probably too long in the past. And these two measures have really helped us to revamp the ingredients business after two years of really not-so-good performance. We're pretty happy with what we are seeing. Is that answering your question, John?

John Roberts - *UBS - Analyst*

Yes. And then North American beverage?

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

North American beverage?

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

I think some of it is, as we talked about -- alluded to earlier, I think the win performance in both businesses is pretty good. But particularly on some of the beverage -- I mean on the flavor side, the lifecycle of those wins has been shorter than what we've seen in the past. So the erosion impact is principally what's driving down or pressuring the performance year-over-year.

John Roberts - *UBS - Analyst*

Okay. And then Rich, I think you said compliance and litigation costs reduce margins by 100 bps versus a year ago. Could you provide some additional details on that?

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

The drivers really are two things. One, you saw in the Q that we have a case going on, and we are actively pursuing that and vigorously defending that. But that costs money. And as we prepare for trial -- potential trial early next year, we're getting prepared around -- that's a piece of it.

The bigger piece of that is really related to the reach requirements in the fragrance business. And it goes through a cycle where there is another -- the next cycle is in 2018. And so we have to prepare for the registrations now. When we incur cost this year, we incur it again next year. And then the following year, potentially we get a little bit of money back from other companies that use our products. But it's really the registration and compliance costs associated with our materials that we operate with in the European environment.

John Roberts - *UBS - Analyst*

Thank you.

Operator

Faiza Alwy, Deutsche.

Faiza Alwy - *Deutsche Bank - Analyst*

I just wanted to again go back to North American flavors. Ottens was in the base this quarter. Can you talk about how that business performs? Because I think the worry is that -- I know it's run separately, but do you think you are experiencing any dis-synergies as Ottens becomes part of a larger company, and some of your customers are more used to doing business with a company that's more agile and quick to deliver a solution?

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

Actually, no, because we keep that platform quite separate in terms of how they act. The only thing we are doing is that we are delivering our technologies to make sure that they can use these more high-tech solutions as well. So, dis-synergies we don't see actually. So now the next thing is actually combine it with David Michaels because that's important. The good thing is that both companies are in Philadelphia, which makes it much easier -- if they would've been in different cities. So, no, we don't see dis-synergies.

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

Faiza, I think -- as I mentioned earlier, one market I think is pressured, and certainly some concerned key clients. The lifecycle on the wins was another factor. I think we expect to see improvement in a strong rebound in Q4, so I think it's more short-term than we think anything long-term or structural.

Faiza Alwy - *Deutsche Bank - Analyst*

Okay. Great. And then Rich, could you just expand on the manufacturing costs? I think you said that was on the fragrance ingredients business. So, was there something specific that happened this quarter and it's not expected to continue next quarter? Or just a little more detail around that.

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

Sure. No problem. I think it is really -- it is primarily manufacturing yields in the ingredients business that I alluded to earlier. Q3 last year was a very strong result, so I would say above-average productivity. Our planning was to expect us to be more or less in line with the historical trends on average, and we came in below that in the quarter.

So the year-over-year impact is bigger than the absolute impact. I don't think it's structural. I think there's a lot going on in the fragrance ingredients business in terms of the runs and the product mix, which we are working through and working to optimize. But I don't think it's a long-term challenge. I think it's certainly -- the big impact was a function of year-over-year performance going two different directions.

Faiza Alwy - *Deutsche Bank - Analyst*

Okay. Great. Thank you.

Operator

Jeff Zekauskas, JPMorgan.

Silke Kueck - *JPMorgan - Analyst*

It's Silke Kueck for Jeff. How are you?

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

Good morning.

Silke Kueck - *JPMorgan - Analyst*

What is the EBITDA that you expect from the acquisition next year? Typically, EBITDA level is something like 50%. Do you think the business can contribute -- I don't know -- $80 million EBITDA next year, or it will be something lower than that?

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

50%? I'm -- Silke, let's come back on that one off-line. But I think you can look at -- if you look at the kind of amortization levels that are in the Q in terms -- that we provide visibility in the Q and the press release, I would expect similar levels -- obviously we have to go through the details over the next several quarters. But I think that overall profitability -- the two businesses are pretty close to our existing businesses. And I think the existing amortization levels for Ottens and Lucas Meyer's is a close-enough proxy to use to try to estimate what the EBITDA levels are.

Silke Kueck - *JPMorgan - Analyst*

I apologize, I didn't mean to imply EBITDA levels of 50% -- so, EBITDA levels somewhere like in the mid-20%s. So I apologize. I miscalculated something. But do you think that the mid-20% EBITDA level is something that's reasonable?

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

It's certainly not short-term, but long-term I think that it should be -- again, it's our core business, and there's no reason why it shouldn't be similar to what our existing business is.

Silke Kueck - *JPMorgan - Analyst*

That takes some time. Okay. In terms of the strategic investments you are making, do you expect to make similar investments in 2017? And is there any quantifiable benefit that you can sort of indicate? Like, is this something where you see a benefit over like a two-year period or a three-year period? What do you get from it?

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

I talked about the reach expenses, which is more on the compliance. And from a strategic investment standpoint, some of that work was related to embedding the ZBB principles. And as I mentioned earlier, we'll expect to begin to get those benefits next year. And I would expect those things to continue to build over the medium- and long-term. I'm not ready to say today exactly what those are, but we're going to get benefits related to that.

Another key part of the strategic investments is more the overall profitability -- the business in leverage, not only at the operating profit line but at the EPS line.

Silke Kueck - *JPMorgan - Analyst*

And is there a level of investment you expect for next year that's quantifiable?

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

I think that, year-over-year, the level of investments will likely go down a little bit next year versus this year. It's part of the dynamic that I mentioned earlier of managing strategic investments versus growth versus reinvestment in the business. And we've got to work with the entire management team in working that balance, and so part of that will be moving those three levers. But I do expect some of those costs to come down year-over-year.

Silke Kueck - *JPMorgan - Analyst*

Then my last question is in terms of your business in Europe -- is the business in general terms and sort of like -- the same? Is it slowing? Is it growing? Have you had any -- do you have any views on whether you are affected by the exit of the UK? What are business conditions like in Europe?

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

I probably can take it. I would say first of all it depends on the category on the business. We see still growth in flavors. But in other parts of the region is Europe, Africa, Middle East. And that's one thing -- we suddenly see stronger growth in Africa and Middle East here than we see in Western Europe. So it's not great growth trends we are seeing.

In general also on the fragrance business, it's slower than what we see in other regions of the world (multiple speakers). So I think it's a tough environment for us. The Brexit -- I would say there's no impact for us right now despite the currency impact. We are all having it at the moment, and it all depends on how finally the deal is negotiated with the UK and the rest of Europe. But right now I think it's a pretty limited impact we are seeing.

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

Then I think the other thing on consumer is we mentioned earlier about one of our large customers -- and so I think that's in the short-, medium-term, that's something that we have to work through.

Silke Kueck - *JPMorgan - Analyst*

Yes. Is that something that you will anniversary at a point in time? Because the divestiture happened a while ago.

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

I'm not sure I --

Silke Kueck - *JPMorgan - Analyst*

I'm assuming that you are referring to a fragrance divestiture by one of your larger customers [Coty]. I imagine that's what it is. But it happened some time ago, so I was wondering is this like anniversary like a headwind from that.

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

My comment was around -- the large customer was also -- was more on the consumer side. So I think fine, we talked about the issues with the customer. But I think we are seeing volume pressure and erosion in one of our big consumer fragrance customers that we have to work through. And that's not going to be lapped yet.

Silke Kueck - *JPMorgan - Analyst*

How many quarters are there to go?

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

It's at least a couple more quarters.

Silke Kueck - *JPMorgan - Analyst*

So it just began, then. Okay. That's helpful. Thanks very much for the detail. Appreciate it.

Operator

Jonathan Feeney, Consumer Edge.

Jonathan Feeney - *Consumer Edge Research - Analyst*

I wanted to dig in a little bit on the gross margin piece of this, especially the two-year progression. Am I right, Rich, that fine fragrance is a significantly higher gross margin than the rest of the business? Is there any way you can kind of quantify for us on a basis-point basis -- just give us an indication how much of the two-year slowdown here -- which has been on a two-year basis pretty dramatic from the second quarter to third quarter. Was that fine fragrance shortfall, and you were making a lot of money before. And maybe how much is other things like currency or the contribution from Lucas Meyer and Ottens? Thanks very much.

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

Sure. No problem. I think, as I said earlier, fine is our most profitable category on the fragrance side, beverage is the most profitable category on the flavor side and both of those were pressured in Q3. I'm not going to provide details in terms of how much that is, but they are well above average. So the mix impact is a significant pressure, and you saw in the quarter what kind of impact that can have.

Jonathan Feeney - *Consumer Edge Research - Analyst*

Maybe this is a simple question, but how does currency impact you at the gross margin line over the past couple of years? Does it hurt you at all?

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

We try to strip that out. And so -- but it's a complex supply chain in terms of where it can go. It started at the ingredients plants and go through our ingredient plant network and then through the compounds plant. So there's a time lag impact, there's a multiple currency impact. We do our best to try to isolate that and pull that out of the individual drivers. So, what you see in terms of as we talked about volume price mix is our best estimates on X currency.

Jonathan Feeney - *Consumer Edge Research - Analyst*

I understand. Thank you very much.

Operator

Gunther Zechmann, Bernstein.

Gunther Zechmann - *Bernstein - Analyst*

When you look at raw material costs, some of your competitors have started building strategic inventories. You seem to follow a different strategy on your net working capital, and cash flow was strong. But you took a hit on the P&L. How should we think about the way you handle raw material cost inflation? And what raw material impact also do you see going into year-end 2017, please?

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

I think, Guenther, as I mentioned earlier, we do expect to see modest input cost pressures next year. We do have strategic stocks similar to our competitors. The exact strategy may not be the same, and so it's hard for me to comment versus what we're doing versus they are doing.

As I mentioned earlier in my comments, one of the key things that we're seeing pressure on the flavor side is on vanilla. David Michael has a tremendous amount of experience in that area, and we're already looking to leverage that to help us in that market going forward.

So we do work with our procurement teams in terms of looking out six to 12 months on a rolling basis and make decisions around strategic stocks. Some of it can be driven by the mix of the business, though.

Gunther Zechmann - *Bernstein - Analyst*

What other than vanilla are strategic stocks for you?

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

We've got vanilla. We've got -- most of it is the natural side of it. Natural citrus, some of those things, patchouli are the key things that we have strategic stocks in.

Gunther Zechmann - *Bernstein - Analyst*

Okay. Thank you.

Operator

Heidi Vesterinen, Exane BNP Paribas.

Heidi Vesterinen - *Exane BNP Paribas - Analyst*

Just on the input costs question again, I wondered if your ability to recover input cost pressures due to pricing differs by customer type or product area. I wondered, for example, is there a difference between global and smaller customers. Thank you.

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

I think, Heidi, clearly our objective and our strategy has always been to cover our cost. It has an impact -- it can have an impact on our margins because as we recovered sort of the pure math of that, can have a dilutive effect on our margins. The market is tough right now, as I mentioned earlier, with certain categories of customers, but our objective is always to cover the cost.

Operator

At this time, I would like to turn the call back to Andreas for closing remarks.

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

Thank you very much for everybody participating. Thank you for the vivid Q&A, and we will see each other or talk to each other on the next call. Thank you. Have a good day.

Operator

Thank you for joining today's IFF. You may now disconnect.
