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IFF - Q4 2017 International Flavors & Fragrances Inc Earnings Call

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OVERVIEW:

Co. reported 4Q17 consolidated currency-neutral sales growth of 10%. Expects 2018 currency-neutral sales growth to be 3-5% and currency-neutral EPS growth to be 4-6%.

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PRESENTATION

Operator

At this time, I would like to welcome everyone to the International Flavors & Fragrances Fourth Quarter and Full Year 2017 Earnings Conference Call. (Operator Instructions)

I would now like to introduce Michael DeVeau, Head of Investor Relations. You may begin.

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

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

Please take a moment to review our forward-looking statements. During the call, we'll be making forward-looking statements about the company's performance, particularly with regard to our outlook for the first quarter and full year of 2018. These statements are based on how we see things today and contain elements of uncertainty. For additional information concerning the factors that can cause actual results to differ materially from the forward-looking statements, please refer to our cautionary statement and risk factors contained in our 10-K filed on February 28, 2017, and our press release that we filed yesterday.

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

With me on our 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, Mike. As usual, I will start with an executive overview of our operational performance for the fourth quarter and the full year. Then I want to provide some key highlights of our strategic progression in regards to our long-term Vision 2020 strategy. Once finished, I will ask Rich to cover our financial results in greater detail, including specifics on each business unit as well as our cash flow dynamics. Then we will both provide commentary as it relates to our outlook for 2018 and finish by taking any questions that you may have.

Starting with the financial review of our consolidated results for the fourth quarter, I'm pleased to report that we had strong operational performance resulting in consolidated currency-neutral sales growth of 10%, currency-neutral adjusted operating profit growth of 4% and currency-neutral adjusted EPS growth of 16%. Rich will take you into greater detail on the fourth quarter later in the presentation.

On a full-year basis, 2017 was another notable year in regards to our financial performance. Consolidated currency-neutral sales growth grew 9% as both business units successfully delivered strong growth with 10% in Flavors and 9% in Fragrances. Overall top line growth was supported by our organic business, which grew 4% on a currency-neutral basis, in line with our long-term financial target, as we capitalized on strong new wins as well as improved volume trends on existing business. In addition, David Michael, Fragrance Resources and PowderPure provided approximately 5 percentage points of additional growth. Led by volume growth, the benefits associated with growth of productivity initiatives and the contribution of acquisitions, consolidated adjusted operating profit on a currency-neutral basis increased 5% for the full year 2017. This improvement when combined with the more favorable year-over-year effective tax rate and a reduction in shares outstanding led to a 9% increase in our currency-neutral adjusted EPS.

We also continued to advance our long-term strategy that will enable us to deliver strong returns for our shareholders. Some key highlights. Sales of our Sweetness and Savory Modulation portfolio continued to grow strong double digits across all our categories, led by Savory, Dairy and Beverage. To ensure we maintain these robust growth dynamics, we successfully launched 3 new natural Taste modulators. Encapsulation-related sales continued to grow, led primarily by Fabric Care and Personal Wash. In delivery systems, the encapsulation platform remains paramount to future growth, which is why we made strong advancements to extend this technology into even more categories.

In the Middle East and Africa, we continued to grow our business up mid-single digits, with growth coming in both Flavors and Fragrances. To ensure we continue to strive in this exciting and dynamic region, we opened a fully renovated and expanded facility in Cairo to better serve our regional customers and strengthening our market presence. In North America, we launched Tastepoint, a fully dedicated organization with -- in IFF designed to serve middle-market customers. This new and innovative go-to-market approach targets the unique needs and expectation of this target customer base, who call for speed, agility and resourcefulness. And it is powered with technology that drives differentiation. Tastepoint performance in 2017 was very strong, improving double digits. Cosmetic active ingredients also remained a growth driver in 2017, as Lucas Meyer's Cosmetics, acquired 2 years ago, continued to grow double digits.

In terms of sustainability, IFF continued its global sustainability leadership as we earned a Gold status designed -- designation by EcoVadis and A-list acknowledgment by CDP for the third year in a row. We were also named to the Euronext Vigeo U.S. top 50 index and saw an improvement in our Dow Jones Sustainability Index score. More recently, we were named Barron's 100 Most Sustainable Companies, an index launched in February 2018 as we joined the ranks of 99 other leading companies assessed by performance in key stakeholder categories.

In terms of capital allocation, we spent approximately $129 million in capital expenditures or about 4% of sales. This was primarily driven by our previously announced strategic investments in operations, including China and India, and creative and application centers globally. We also invested $205 million of capital for 2 strategic acquisitions. We fortified our Fragrance business with an acquisition of Fragrance Resources, increasing our participation in specialty fine fragrances and strengthening our market position with regional customers in North America and Germany. We also purchased PowderPure to further expand our expertise in Flavors by offering clean-label solution that do not compromise taste, nutrition and color. The combination of these 2 acquisitions should add approximately $90 million of expected annual revenue.

We returned approximately $264 million or 56% of our adjusted net income to shareowners through dividends and share repurchases, increasing our annual dividend 8% and announcing the extension of our existing share repurchase

[Audio Gap]

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

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

Thank you, Andreas. I'd like to now turn our attention to the business unit reviews for the fourth quarter. Flavors currency-neutral sales increased 5%, led by strong growth in Savory, Beverage and Sweet. It should be noted that on a 2-year average basis, growth was strong at approximately 7%. From a regional perspective, all 4 regions delivered growth, led by 9% improvement in North America, primarily driven by strong double-digit growth in Savory. EAME increased 5% on a currency-neutral basis, with the strongest growth in Beverage. On a geographic basis, the Middle East; Africa; Central, Southern and Eastern Europe all reported strong growth. Greater Asia grew 2% on a currency-neutral basis, principally driven by robust growth in India and the ASEAN region. And in Latin America, sales growth was 6% on a currency-neutral basis, as growth was led by the Southern Cone region, specifically Argentina.

In Q4, on a currency-neutral segment profit basis, Flavors grew approximately 10%, led by volume growth and the benefit from productivity initiatives. In terms of currency-neutral segment profit margins, we achieved year-over-year margin expansion of approximately 90 basis points to 21.3%.

Fragrance currency-neutral sales improved 15% in Q4, as growth was broad-based and very strong with approximately 10 percentage points coming from our organic business and approximately 5% coming from acquisitions. Regionally, growth was broad-based as all regions increased double digits. It should be noted that Brazil has stabilized as we saw a rebound in overall volume performance. From a category perspective, Fine Fragrances improved 27% on a currency-neutral basis, including Fragrance Resources. All regions achieved strong double-digit growth inclusive of acquisitions. Organically, sales on a currency-neutral basis grew double digits, led by new win performance as well as improved volume on existing business. Consumer Fragrances grew 12% on currency-neutral basis, including Fragrance Resources. Organically, our performance was driven by double-digit growth in Personal Wash and Home Care as well as high single-digit performance in toiletries. Please take note that Consumer Fragrances continued to perform well relative to the first half of 2017, as volume on existing business has remained positive in Q4.

Fragrance ingredients sales were up 14% on a currency-neutral basis, driven primarily by double-digit growth in Latin America, North America and Greater Asia. And as Andreas noted, Lucas Meyer's also continued to perform well in the quarter with double-digit growth.

From a profit perspective in Q4, Fragrances segment profit remained constant on a currency-neutral basis. Volume growth and the benefits from productivity initiatives were offset by unfavorable price to input costs and an increase in research, selling and administrative expenses, which includes higher incentive compensation expense, and an increase in amortization cost associated with the acquisition of Fragrance Resources. This had a corresponding impact on year-over-year currency-neutral segment profit margin, which finished at 16.6% in the fourth quarter.

Turning to next slide. We show the year-over-year pact -- year-over-year impact in terms of contribution of Q4 operating profit growth on a consolidated basis, expressed as a percentage of our restated fourth quarter 27 -- 2016 adjusted operating profit. Starting with the second bar, you can see that volume added approximately 13 percentage points to overall operating profit growth. In the third bar, you can see that we continued to benefit from our cost and productivity initiatives through the likes of procurement savings, our restructuring program savings. Overall, we delivered approximately 6 percentage points of benefit year-over-year. Moving on to the next bar, through disciplined cost management, including components of 0-based budgeting. RSA contributed 2 percentage points of benefit to the fourth quarter adjusted currency-neutral operating profit growth.

Overall in the quarter, mix had a negligible impact. From an M&A perspective, M&A -- from a headwind perspective, M&A was a slightly drag of 1 percentage point. We also at various times went against this in the quarter, which represented about 2 percentage points of headwind. Net price to input costs was unfavorable by about 3 percentage points and was predominantly driven by higher raw material costs in Fragrances. Lastly, incentive compensation was unfavorable by approximately 10 percentage points year-over-year. In terms of year-over-year comparison, we had a large delta, as we compare to a lower-base period in the prior year due to underperformance versus a plan, compared to strong performance in the current year quarter.

As a quick reminder, we are highly incentivized to deliver our financial commitments. From time to time, there are variations in incentive comp as it is based on our performance relative to our plan. If we achieve our financial targets, we'll receive 100% of our designated payout. Should we over or under deliver versus the plan, our incentive compensation is adjusted higher or lower. In the case of '17 -- 2017, incentive compensation expense was higher than 2016, as we exceeded our 2017 targets.

Moving on to cash flow. Operating cash flow was $391 million for the year, which compares to $550 million last year. Our 2017 performance was adversely impacted primarily by the ZoomEssense litigation settlement, higher working capital requirements, acquisition-related activities and restructuring charges. It should be noted that while working capital requirements year-over-year was unfavorable, it improved significantly in the fourth quarter from where it was at the end of the third quarter, mainly due to improved accounts payable.

As Andreas mentioned, from a capital allocation standpoint, we spent approximately $129 million in CapEx, or about 4% of sales, and believe that we will spend between 4% and 5% of sales in 2018. With the current expectation, it will be at the higher end of the range.

Regarding cash returned to shareholders, in 2017, through a combination of dividends and share repurchases, we delivered a total payout of 56% of adjusted net income, consistent with our 50% to 60% targeted range.

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

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

Over the last 2 years, we have seen the global operating environment become more volatile. Fortunately, several of the factors in which we highlighted in the past have started to see modest improvements. To put this in context, we have seen global consumer staple volumes starting to stabilize and show signs of improvement. While it's early in the year, expectation is that the consumer staples volume will improve in 2018, increasing approximately 2%. This compares well to what we, as an industry, have seen over the last 3 years and where the average was flattish to up slightly.

From an economic perspective, GDP growth on a global basis is expected to improve modestly. A key driver for this improvement is expected to come from stronger GDP trends in the emerging markets. This should provide a relative improvement over the last few years in terms of our top line performance, as approximately 50% of our sales are through the emerging markets.

U.S. dollar continues to fluctuate versus the world currencies. And as a global organization with nearly 30 currencies, there are many moving parts. Most relevant for IFF, the strengthening of the euro versus U.S. dollar is favorable as approximately 30% of our profits are euro denominated. However, please remember that the impact on profitability will be limited as we have a rolling hedging program, and our hedge about 80% at $1.15 for 2018. This compares to an average euro to U.S. dollar rate at $1.12 for the full year 2017.

While we are optimistic that the operating environment has improved modestly, the one area that remains headwind is raw material cost. On the natural size, the demand for all natural products continues to drive across all natural ingredients, as has done over the past few years. This can be best seen in vanilla and citrus markets, where prices remain at historically high levels, and turpentine and turpentine derivates, particularly gum turpentine, costs have increased significantly. In addition, synthetics materials are directly and indirectly from oil are exhibiting inflationary pressures. For all of these instances, we have been continue to have active discussions with our customers to recover our cost exposure via pricing.

With that as a backdrop, I would like to highlight several notable items that we expect to impact our financial results in 2018. One of our key suppliers, BASF, had a fire occurred at their manufacturing plant in Germany during quarter 4 2017. This impacted their production of citral, a very common ingredient used in many formulations in both Flavors and Fragrances. In addition, they declared force majeure, which impacts both supply and cost of the key import for the entire flavor and fragrance industry. Based on their public statements, the startup for that plant is not expected to occur until the end of March 2018. We anticipate that the supply chain will not fully normalize until the second half of 2018.

With that, I would like to turn it back to Rich.

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

Thanks, Andreas. Let me take the couple of more technical items. At the end of 2017, the U.S. government enacted comprehensive tax reform. Key changes include, but are not limited to, Base Erosion and Anti-Abuse Tax, executive compensation deduction limits and the elimination of certain special deductions. For us, we accrued a provisional net charge of $139 million in the fourth quarter of 2017, which primarily includes a transition tax on the company's historic unremitted foreign earnings and the reevaluation of the company's net deferred tax assets to reflect the new lower statutory tax rate.

As we think about 2018, based on our current assessment and understanding of the tax act in our current global operating restructure, we believe that our effective tax rate in 2018 will be approximately 21%.

Lastly, in March of 2017, the FASB issued an amendment to the compensation report -- retirements benefits guide and effective in 2018, interest costs, asset returns and the amortization and gains and losses will now be recorded in other income and expense versus operating profit under the previous accounting rules. The impact was approximately $31 million in 2017 and $15 million in 2016.

For modeling comparison purposes, our pro forma adjusted operating profit for 2017 will now be $616 million, and other income and expense will be $40 million, of which $31 million is for the pension change and $9 million is other regular income and expense items.

Given the several moving parts, we felt it was important to highlight the drivers of currency-neutral adjusted operating profit and adjusted EPS for greater transparency. Before doing so, I want to highlight the expectation for sales performance. We expect 3% to 5% currency-neutral sales growth as all categories are expected to contribute to growth. In terms of expected operating -- adjusted operating profit performance in 2018, please take note that our starting point following the pension accounting change is $616 million for 2017. In 2018, we expect the profitability of our core business to accelerate versus the growth we achieved in 2017 from approximately 5% to approximately 7% to 9%. We expect the performance to be driven by the combination of volume growth and the benefits of cost and productivity initiatives, which include our standard program plus advancements in 0-based budgetings and savings associated with the multiyear productivity program that we announced in the early 2017.

Net price to raw material cost is expected to be neutral, as we're taking action to cover our cost exposure. In the fifth bar, we isolated the impact relative to the citral force majeure. While we are pleased to say that we can believe we can meet the demand of our customers, the challenge, however, is that the total financial impact in 2018 is quite large at approximately 7%. Fortunately, we have and continued to work with all of our possible mitigation options, and currently believe the impact should be limited to approximately 2 percentage points.

Inclusive of the impact of the citral situation, we expect raw material costs will rise mid-single digits in 2018. Please note that this is very fluid situation and is based on how we see things today. Our objective is to fully offset the BASF impact, as we're pursuing all options, both internally and externally.

I'll review the impact of currency in more detail shortly.

Moving on to EPS. As you see from the second bar and similar to our previous slide, our core business remained strong. We expect 6% to 8% growth in 2018 from our core business. As I discussed moments ago, the force majeure situation is expected to adversely impact results by approximately 2 percentage points.

Looking at tax, based on our current assessment and understanding of the tax act and our current structure, we believe that our effective tax rate in 2018 will be 21%. And it's inclusive of the net -- the impact of the tax reform net of mitigation and planning opportunities that we've identified today.

The ultimate impact of the tax impact may differ from this estimate due to, among other things, changes in interpretations and assumptions, additional guidance that may be issued by taxing authorities, as well as our operating and structural changes that we may take into result -- take into account as a result of the act.

We expect currency-neutral EPS to be between 4% and 6%.

In terms of foreign exchange, for 2018, we expect currency translation to be a favorable impact on sales of approximately 3 percentage points. We expect currency to be favorable by approximately 1.5 percentage points on adjusted operating profit and adjusted EPS, respectively. Net-net, our 2018 guidance all-in is 6% to 8% sales growth, 6.5% to 8% for operating profit and 5.5% to 7.5% for EPS.

With that, I would like to pass it over to Andreas for some closing comments.

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

In summary, we're pleased with what we have achieved so far across all key financial metrics in 2017. As we enter 2018, recognizing that uncertainty remains in the operating environment, we are targeting growth across all of our key financial metrics. We're doing so by taking action to accelerate sales growth in advantage categories, deliver innovation that is truly differentiated and generate higher returns via continued cost and productivity initiatives and generate strong returns for our shareholders. And we have started the year 2018 well with growth across both business units.

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

QUESTIONS AND ANSWERS

Operator

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

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

Wanted to ask first about the sales growth outlook. So if you keep the 2-year constant, it would imply growth at least at the midpoint, maybe even a little bit stronger than that. So I guess, I'm curious why are you including a wider range at least compared to last year? And what if they happen to come in at the low end and at the high end?

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

Yes. Look, Mark, first of all, we are certainly optimistic for 2018. But with all the volatility we have seen in the last, let's say, 2 years in the market, plus the citral situation we are having at hand right now, we said it's more prudent to go in with a wider range and then probably update over the course of the year. So that's our view on it. Yes.

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

I think, the other thing for me, Mark, is as we talked about on the last call, I mean, we're still -- it's still unclear to what extent the improvement we've seen late in '17 and how much of that is going to be volume impacts and inventory at our customer levels and restocking. So I think that's why -- some of those factors are why we use a wider range this time.

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

Got it. And just to elaborate on that, and then I want to ask the second question. Six weeks into the first quarter at this point, so I guess, maybe color as it relates to your last bit of commentary would be helpful in terms of sort of how you're seeing things so far. And then just switching a bit to growth margin. So your ability to take pricing given, obviously, higher input costs now, the BASF issues and the commentary from last call about slightly pushback from customers in terms of the ability to take pricing or at least their pushback on needing to hit their own internal earnings target. How do you think about the puts and takes that where we are? And how do you think about the longer-term ability to grow growth margins relative to the level where you were at the end of '17?

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

Yes. Okay, I'll take that. So as we said, the start into the first quarter was a very, very good start, what we have seen so far. So -- and we are closing in February next week, which is good, good data point. On the pricing, we are certainly in negotiation with our customers. We believe that we can recover our pricing. As you well know from the past, it will take some time to recover the pricing. You always had a -- have a time lag in it, whether it's based on inventory or the negotiation of the contract you have in place, but we are fairly optimistic that we get it done. But we have to recognize all. It's a very complex situation for us right now, because on one hand you have the raw material prices, on the other hand, you have the BASF situation, which are completely 2 different animals. And I think that, that's not easy to explain. But I hope when we are through the whole situation BASF situation, it's easier to show where we are. That's pricing. And growth margin, on the fourth quarter what you have seen probably a bit of a mix impact and the raw material, but we certainly want to make sure this year that we work on the mix to make sure that we are really very well in place and about the raw material and the pricing we talk. But I don't know, Rich, whether you want to add on this?

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

Yes, sure. I mean, I think it -- I mean, just to echo a couple of Andreas' comments. At the end, I think it was a -- it has been a good start to the first quarter from a margin perspective. We've had some -- in Q4, some productivity, some one-off items that we saw in the quarter. As I think about 2018 margin relative to 2017, as you said, Mark, we're going to have pricing increases to cover the normal input cost increases. On top of that, we've got BASF. So that by definition is going to put pressure on margins for 2018. We've got some of the carryover pricing more in the first half, obviously, in the second half from our customers. So that's going to put further pressure, I think, in the first half of 2018. And then, as you saw in the operating profit bridge, I mean, the 2 percentage point net impact that we currently believe is achievable in '18 for BASF is going to have a direct impact on margin. So when I look at in total, I'd say that our expectations for margins in '18 are probably flat to maybe down slightly.

Operator

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

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

So just looking back at your initial expected profit bridge for 2017 that you gave last February, I was wondering if you could talk about what performed better or worse than you initially expected? And did you achieve the 4 to 4.5 points of benefit from productivity and cost savings?

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

Sure. Thanks, Kate. No problem. There is a lot there, but let me try to stick with the highlights. I think top line growth was better than what we expected. So overall growth in the business was better than what we expected. I think you've heard us talk throughout the year, M&A, particularly, the Flavors, Tastepoint business performed well and probably exceeded expectations. Price input cost was -- I would say is unfavorable. We've had the pricing pressure on, particularly in Fragrances that we've talked about since the middle of the year. So that was a negative. Mix, particularly, in the middle part of the year was a big drag that we talked about on the second and third quarter calls. From a productivity standpoint, I think we were slightly ahead of our goals for 2017 in terms of the profit-improvement program. The components may have shifted a little bit, but we're slightly ahead of where we expected to be.

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

And just one other thing on the strength of North America Fine Fragrances. Just wondering if it was due to any one customer, in particular? Or if -- and then, like, the split between existing business and new wins.

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

It was actually not one customer. So it was more across the board was broader, which is good. And the volumes went up as well, which was driving it. So all-in-all, very, very positive, because it's not a one-off and it's just not one customer.

Operator

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

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

In terms of the BASF situation, does it affect Flavors more or Fragrances? And maybe can you talk about the core growth in each of those segments in '18 based on your outlook?

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

Yes. Mike, it's primarily Fragrances in terms of BASF. The principal impact on Flavors is on menthol. But the vast majority of the impact is on the Fragrance side, because it's used in so many different formulas. In terms of growth in the 2 business units in '18, there is -- I think, it's pretty similar growth expectations for both businesses.

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

Okay. And for the citral situation, is it more your inability to get the raw material versus the higher prices? And are there other ways to may be source some of these materials?

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

No, I think, Mike, we're -- we actually feel very good. And I think you heard it in Andreas' comments that we're actually well positioned, and we feel good that we've been able to maintain continuity of supply to our customers. However, to do that, we're having to deal with increased input costs and the market pricing has driven dramatically in late -- beginning in October and November when the -- when BASF had first made the announcement. We've had to make choices internally and shift internal capacity. We're vertically integrated. So part of the impact that we're seeing is we're having to give up external sales on Ingredients in order to give preference to our customers, though it's a variety of factors. Most of that is the input -- the actual cost of the input, cost and some incremental manufacturing expenses to get the product in the right place, some work in terms of Nicolas' team from a creation standpoint to be able to adapt with changes that the customers are asking us for.

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

Great. And then last one. Andreas, when you think about the trend to naturals. Can you maybe just give us an update on where we're at there? Are you start -- are you continuing to see a lot of momentum in new product development from customers? And what NA do you think we are in that trend longer term?

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

No, Mike, absolutely. The trend stays and it's gaining even momentum. We have it, as you well know, on the Flavors already, because 90% of our, let's say, briefs in North America in Flavors are basically for naturals. So you see -- and that's why we're catering with our PowderPure acquisition as well. So we are strengthening even our position here. But now we see it more and more on the Fragrance side as well, and not just on the pure fragrance, also on the active cosmetics. That's a natural element, plays much, much a bigger role. And I don't expect that this will go away. So that's something -- a trend which is still pretty much intact.

Operator

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

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

It's Silke Kueck for Jeff. So my first question is just a question of clarification. So what you said is that there was $15 million pension-related benefit in 2016 that you now will capture in other income. And there was an even higher pension benefit of $30 million in your 2017 operating income, which will now become part of other income, so, effectively, your operating income in '17. So it's like, we're really at a slower rate, right? So it's, like, went from $605 million to $616 million, is that correct?

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

Yes. I mean, it's part of our normal pension expenses and what we have to deal with as a company year in, year out. I mean, for a long time, the cost was going up every year, and we were having to absorb it, particularly, post-Lehman crisis when asset returns were hurt significantly. So it's a function of -- it's a function of the overall economics of the business that we've had to deal with over the last several years.

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

Secondly, how do you think about incentive accruals in 2018? Will that be headwind, the benefit? Do you have some thoughts about that?

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

I would say, it's going to be -- it should be flat to slight benefit.

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

And in terms of your tax rate, there's various change that's taking place. Will there be a change in your cash tax rate? Or can you tell us what your cash tax rate was in 2017 and what you expect it to be in '18? As best as you can tell with the information that you have today.

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

What I can say is that I don't have my cash tax rate off the top of my head. I mean, obviously, if you think about the charge we recorded, it's a $139 million, about $100 million of that is the transitional tax, the remaining part of that is a reevaluation of the deferred tax assets on our balance sheet. That $100 million, the actual amount we're going to have to pay over the next 8 years is going to be, probably call it, 2/3 of that number, because of credits we have available. So from a cash standpoint, that's going to hurt us in '18 versus '17, because we're going to have to start to make that payment spread over the next 8 years. So I would expect our cash effective tax rate to be worse than it was in '17.

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

And I've got a final question on the Fragrance business. Like, the underlying -- like, even if I strip out the acquisition, it looks like Fragrance sales in North America were really exceptionally strong. So I was wondering whether you can sort of, like, talk about the Fragrance business in North America. What it may -- what rate it grew at in the individual divisions, excluding the acquisition and what was behind that?

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

Yes. So I mean, it's overall -- I mean, the effect of -- I mean, big part of that on the compound business in total would have been -- it's about half of the compounds, a little bit, call it 1/3 of the growth, it's about 10% growth, double-digit growth in compounds in total, and their balance is going to be Fragrance Resources. Fine Fragrance grew -- again, on an organic basis, grew high single digits, Consumer Fragrance grew low double digits. So it's pretty strong across the entire business in North America. Win rates were pretty consistent with what we've seen, but the big piece was volume recovery on existing business.

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

Yes.

Operator

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

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

So just 1 or 2 questions from me. First of all, can you talk a little bit more about the pricing pressure that you are seeing from your customers? Is this something new in terms of because the competitive environment changed. Because historically, the view was that Flavors and Fragrances are such a small percentage of products overall costs, that there isn't a lot of pushback from customers, but that's clearly changed over the last, I would say, year or so. Can you just, Andreas, maybe give us a little bit more perspective on perhaps if the competitive environment is having an impact on that?

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

Sure, Faiza. I mean, I think there's a couple of things to keep in mind. I mean, we've talked -- they are customers, particularly, our global customers. We've talked about this for the last several calls about having significant productivity improvement programs in their business. So we're not immune to that. We talk about how we deal with that in terms of a combination of pricing, reformulation, substitution, tradeoffs. So I mean, I think, the pricing pressure was more significant in the middle part of the year. If you look at pricing in Q4 for Fragrances, it was slightly positive. So I think we talked about during the course of the year that we -- it was going to get better. I think, as I said, I expect to see some carryover impact in early 2018. But it's never easy. I'm never going to sit here and look at Nicholas or Matthias in the face and tell him it's easy to raise prices in their teams. It's a lot of work. It takes a lot of focus and discussion. We've got contracts we have to deal with in terms of when the windows open up, what the thresholds of the increase have to be. So it takes, I think, over the time, and we've shown that pretty consistently over the last 10 years that we can get there. Sometimes, it takes a little bit longer than we want to.

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

Yes. No, I'm fairly optimistic on this one as well. I think we know how to deal with it. We know how to operate in that environment. And this year, as we said before, it's a little bit more complex because we have to distinct between the raw material price increase and the BASF situation, which makes it not easy. But we are fairly optimistic that we can do it as we've done it before.

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

Okay, okay. And then, Andreas, can you talk a little bit more about your M&A outlook strategies? What are you focused -- most focused on in terms of targets for -- especially for 2018? And then just, Rich, the cash flow, as you mentioned, was pretty weak in 2017. Do you have any targets or goals that you're looking for in 2018?

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

No, look, Faiza, as we have done it in the last 3 years, we have all our list we're working on. We are actually very happy that all the 5 acquisitions we have done in the last 3 years are actually performing all very well. And actually all above the business case, which is a very, very good thing. And there is nothing extraordinary what I can announce right now. But we are certainly, let's say, going forward with our strategy, which is described in our Vision 2020, where M&A is an active pillar of our strategy. We're certainly looking at a couple of exciting technology moves as well, but it's too early to talk about it.

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

From a cash flow standpoint, Faiza, I mean, clearly '17 was not a good year. We're down about $160 million year-over-year in cash flow from operations. I mean, some of the pieces you're already aware of and everyone is aware of: the litigation settlement, $56 million; working capital was about $45 million higher. It's an increase in terms of cash outflow. I mean, we did improve as a percent of sales by about 20 basis points on our core working capital, but it was well below what our expectations were. On top of that, there's probably about a $25 million-or-so impact on our cash flows this year -- or last year, '17, related to the productivity-improvement program, the acquisitions and the integration costs related to that. So the balance of it, call it $30 million-or-so is really around indirect taxes, prepayments, some of the more normal day-to-day stuff. Expectations for next year, obviously, is going to be significantly improved. If you take out just the 2, I'll call them more one-offs, the litigation and the integration-type things and productivity program, that's $80 million in itself. And then we're going to have the increased profitability of the business, and we're certainly targeting improvements in working capital this year. I think, it's going to be -- working capital is probably going to be back-ended, because we're going to have to deal with inventories and pricing associated with citral in the first half of this year. And we'll get the pricing in the second half of the year, as I talked about earlier. So I think, it's -- the improvement's going to be back-ended. I am happy to say that, if I look at the fourth quarter alone, cash flow in '17 was only slightly below what we saw in '16. So it was a tough start to the year undoubtedly. First 9 months of the year was where most of the gap in cash flow generation occurred.

Operator

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

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

How much of the sales growth in Fragrance Ingredients was priced to pass through the higher raw materials? I think if that segment is the most impacted and fasted impacted with raw materials.

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

It's true. John, it's Andreas. It's true, but not yet. It's too early that the pricing will come down in the first half of the year.

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

So that was mostly volume then?

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

It was basically -- you might remember up to 2 years ago, we were not growing in Fragrance Ingredients, and we had to turnaround the business and came up with a turnaround strategy. And now the team is basically executing on the turnaround strategy and has a lot of innovation in the pipeline as well, which means new molecules we can offer to our customers. And that's yielding right now. So there's basically no pricing up to now.

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

Well. And then, Rich, given 80% of your sales are outside the U.S., I was surprised that you were able to lower tax rate as much as you did. Is there anything significant beyond just statutory U.S. rate decline?

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

John, there's -- there are so many moving pieces. I think, obviously, that's the biggest piece of it, because I mean we've got executive complements that are headwind we have to deal and manage through the basis erosion tax, the BEAT tax. So -- but if you the -- if you sort of boil it down on one thing, it's going to be the rate reduction.

Operator

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

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

Can I just ask on multinationals versus regionals in your customer group? So is that still 50-50 or has that shifted because the number of the acquisitions that you've made are targeted towards those faster-growing local champions? So could you give an update there? And then in the slide deck, you expect, on Page 14, an acceleration of CPG companies from 3-year average of 0.4% to 2% in 2018. What's that based on, please?

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

Sure. Probably, I'll start with the last one. For the CPGs, it's basically street expectations, which we talked. So Mike extracted that, and we put it in. And on the customer side, we are around about still 50-50. But certainly would have better growth rate on the smaller customer. So it probably will tilt a bit towards this over the next couple of months.

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

Okay. And can I just check on the 2% of the CPG companies. I know it's early in the year. But is that something that acceleration that you're observing in your orders as well?

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

Yes, we do. Absolutely. And then we saw already with the volume, because the volume is helping in the fourth quarter.

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

Second half of the year. I mean...

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

Or second half of the year you can say, in particular. For Fragrance, it was actually a pretty strong turnaround. I'm sorry, Q1, I forgot about this, but we see it in the first couple of weeks here in the new quarter as well.

Operator

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

Fintan Ryan - *Berenberg, Research Division - Analyst*

I just have a question in terms of some of your key geographies. Wondering could you give a bit more color on what you're seeing on the demand side in Brazil, Latin America and China within the Greater Asia region? They have been areas of relative softness over the recent quarters. And I guess, the outlook for 2018. Do you see the emerging markets acceleration driving the sales growth? Or do you expect growth to be sort of broadly split between developed and emerging markets?

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

Thank you for the question. I'll start with the last one first. We see actually a broad-based growth over all regions for 2018. In specific on Brazil or LATAM, we see -- or we have seen that it turn around Brazil for the Fragrance business actually in the second half, which is a good sign, because it's a very important market for Fragrance. And it looks like it will stay like this for '18 as well. On Asia, we see very, very strong growth in India, very double digit. And you might have seen that we have announced the building of 2 new factories, Fragrances and Flavors, actually the biggest one in that case in India. In China, it's still a little bit of a rough patch. You might remember 2 years ago, we had the incident in our Flavors factory. We are building a second backup plan, which will be inaugurated probably end of third quarter, fourth quarter this year, so that we are over this hump as well and can produce against good growth coming out of China. But again, the emerging markets are coming back, which is great, but what we have seen is actually very good growth out of the United States, as you have seen, and also Western Europe. We shouldn't underestimate that, and that's still a pretty significant piece of our business. So all in all, a pretty broad-based approach. With a couple of pockets where we believe good growth comes on, like Brazil, for example, or India.

Operator

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

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

I was hoping to go back to the sales growth guidance and just to be clear. So 3% to 5% currency-neutral growth, the company did 4% organic, a little bit -- couple of basis points above that in 2017, so middle of the range. You've talked about your customers expecting an acceleration in volume growth in 2018. You've talked about your orders being healthy at the start of the year. And there is an expectation that pricing will be accelerating as you move through the year to recover raw materials. So I'm just trying to think about that organic sales growth guidance and why there wouldn't -- what's decelerating in the mix to get to the 3% to 5% range if you have those kind of pieces moving where they are actually right now?

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

Sure. It's Rich. Let me try to give -- I think, you heard our comments earlier around -- there's still a fair amount of uncertainty in the market. And so given that, we took a wider range. I mean, I think certainly as we look at the components, we probably have about a 1.5 of growth embedded in the guidance related to pricing. The remaining is the volume impact, but I certainly hope that we can be at the higher end of the range and beat that. I think as Andreas talked about earlier, we've had a good start to the first quarter, but 6 weeks don't make a year or 7 weeks don't make a year. The situation -- the supply situation and the pricing impact and the impact that's going to have as we work that through in both businesses is probably the key drivers on why we've taken a relatively cautious approach in terms of our guidance for '18.

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

But we certainly can give you more details as soon as we know when the BASF plant is up on stream online again. And then in our, what is it, second quarter -- first quarter call, we can give you a good update where we see things panning out. But I would echo Rich's comments here. It's a lot of moving pieces right now and that's the reason why we said, let's be prudent here and then come up with that guidance.

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

Okay. And then just a quick clarification on the EPS guidance, the 4% to 6% currency-neutral against the 5% to 7% operating profit currency-neutral growth range. Tax rate's flat year-over-year. What below the line would be causing EPS to grow slower than operating profit?

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

Yes. No, it's a good question. I mean, I think there's a couple of things. I mean, tax is slightly unfavorable, so that's going to be a piece of -- it's a little bit. In '17, when there is elements of other income that we don't forecast or beat, sort of the miscellaneous items or one-off items really the only thing we embed into our guidance for the current year, i.e. is going to be the interest income component of it. The rest of it, miscellaneous sales and gains, we do not include in that guidance. And then the last piece, there is -- the -- given what's going on in terms of our pension plans, interest rates, the amortization schedules on the unrecognized gains and losses, the benefit in '18 versus '17 for the pension change is a slight headwind also. Interest expense, we are forecasting -- that's the other piece, we're forecasting to be higher in '18 versus '17.

Operator

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

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

I joined the call a little late, so I apologize if you guys already talked about this. But on the Fragrances business in Q4, that year-on-year margin declined. I think, it was roughly 200 basis points, if I'm not mistaken. Did -- can you or did you parse out the margin impacts by group, mix being one, price recovery of inputs being 2, and then just 3, higher core operating costs?

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

We don't -- when I'm breaking out the individual components, I would tell you sort of the big buckets. I mentioned in my comments, Andreas' comments, we talked about unfavorable -- higher input costs in Q4 for the Fragrance business. Pricing was up slightly, but not enough to offset the increased input cost. We've got the negative impact principally related to incentive comp reset and the performance of the business. And to a lesser extent some, I'll call them, selected investments in RSA. Those are probably the 3 biggest drivers.

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

Okay, that's helpful. Sorry if you had to repeat that.

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

And the amortization -- sorry. No, it's okay. And -- sorry -- and the amortization cost is the other piece of it, which I didn't have to recall.

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

Okay. Maybe hanging on to the raw material discussion. So we understand that a fair amount of the drive higher in synthetic raws is related maybe to a stance by the Chinese government where it's becoming a little bit more focused on manufacturing in certain regions in country. And I'm just kind of curious what you are seeing from that region. I know you have a couple of plants there and you're working to make some consolidation efforts. If you are just seeing any disruption or if it's kind of just business as usual for you guys?

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

No. I would say, it's business as usual, in particular in the materials we are buying. So there is nothing extraordinary. But...

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

No, I mean, I would probably say, it's -- I'm not sure I would have called it business as usual, given the investments we've had to make over the last several years in moving plants to work as good partners with the government, both on the Flavor side and our Ingredients business. We talked about that on the -- in the third quarter call, our 2 Ingredients business. But I mean, we feel good about our ability to operate going forward. I think there's probably been some small intermittent issues where local players are going to have to may be dealing with the government coming down on them. But I wouldn't say there's anything significant from a supply chain issue that we are seeing.

Operator

Your next question is a follow-up question from the line of Gunther Zechmann with Bernstein.

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

Just a follow-up. Can I check on Dairy? And what happened there in Q4? It's still in the area you don't explicitly split out this contributing to growth. And I thought that's the one area where the vanilla pricing be passed or have passed on should contribute to organic growth.

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

I think part of it -- I think, probably the biggest driver, Gunther, is the prior year comp being quite strong.

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

Okay. So the outlook for '18 is unchanged?

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

Yes. It's positive. Yes.

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

Yes.

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

There's nothing fundamental in the business has changed.

Operator

There are no further questions at this time. I would now like to turn the call back over to Andreas.

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

Thank you very much for your attention and the questions. And we certainly will follow up by one-on-one calls. Thank you very much, and have a good day.

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

Thank you.

Operator

This concludes today's conference call. You may now disconnect.
