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INGR - Q3 2016 Ingredion Inc Earnings Call

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OVERVIEW:

Co. reported 3Q16 net sales of $1.5b and reported EPS of $1.93. Expects 2016 net sales to be in line with 2015 and adjusted EPS to be $6.95-7.10.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Ingredion third-quarter 2016 earnings conference call. For the conference, all participant lines are in a listen-only mode. There will be an opportunity for your questions and instructions will be given at that time. As a reminder, today's call is being recorded.

I'll turn the conference now over to Miss Heather Kos. Please go ahead.

Heather Kos - *Ingredion Incorporated - VP of IR and Corporate Communications*

Good morning, and welcome to Ingredion's third-quarter 2016 earnings call. Joining me on the call this morning are Ilene Gordon, our Chairman, President and CEO; and Jack Fortnum, our Executive Vice President and Chief Financial Officer.

Our results were issued this morning in a press release that can be found on our website, Ingredion.com. The slides accompanying this presentation can also be found on the website and were posted a few hours ago for your convenience.

As a reminder, our comments within this presentation may contain forward-looking statements. These statements are subject to various risks and uncertainties. Actual results could differ materially from those predicted in the forward-looking statements, and Ingredion is under no obligation to update them in the future as or if circumstances change.

Additional information concerning factors that could cause actual results to differ materially from those discussed during today's conference call or in this morning's press release can be found in the Company's most recently filed Annual Report on Form 10-K and subsequent reports on Forms 10-Q and 8K. During this call, we will also refer to certain non-GAAP financial measures, including adjusted earnings-per-share, adjusted operating income, and adjusted effective tax rates, which are reconciled to US GAAP measures in note to non-GAAP information included in our press release.

Now I'm pleased to turn the call over to Ilene.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Thanks, Heather, and let me add my welcome to everyone joining us today. We appreciate your time and interest.

I am pleased to announce Ingredion ended the quarter with strong operating income and earnings per share. North America had record high operating income. APAC and EMEA were up year-over-year, and South America, although down slightly due to difficult macroeconomic conditions, performed better than expected.

Total volumes declined 1%, driven by macroeconomic headwinds in South America, and the sale of our Port Colborne, Canada facility last year. These declines were partially offset by stronger volumes in APAC and EMEA. Like last quarter, our price/product mix was favorable, driven by specialty sales and a favorable trade-up of our core Ingredion sales. Our focus on continuous improvement and global network optimization has supported the margin expansion.

Overall, I'm pleased that our business model and strategic blueprint continue to deliver shareholder value. And to that end, we announced an 11% increase in our dividend in September.

Our ongoing cash flow from operations continue to enable us to deploy cash to advance our strategic blueprint. In fact, the successful startup of our North America specialty ingredient capacity expansion we mentioned last quarter is being followed by our Asia capacity expansion. This expands our global network with increased production capacity and more timely delivery of our unique, higher-value specialty solutions.

Now, let's spend a moment on each region's performance in the quarter. Operating income in North America was $164 million for the quarter, up $31 million from last year. Overall volumes were down 3%, driven by the sale of our Port Colburn facility. Price/product mix was up, driven by both specialty and core Ingredion sales.

Continuous improvement initiatives, network optimization, and lower input costs, continue to drive good operational efficiencies throughout the region. And our capacity expansion in Mexico is progressing nicely, which will be available to support both specialty and core ingredient growth in 2017.

In South America, operating income was $27 million, down $1 million from last year. The macroeconomic conditions continue to be challenging. Pricing actions, good cost discipline and continuous improvement projects unfortunately were more than offset by higher corn, energy, and other input costs and softer volumes.

We continue to rightsize the business and accelerated our planned closures of two facilities in Brazil this year. Brazil's economy continued to feel the effects of negative growth. Given the macroeconomic environment, our local leadership team continued their ongoing focus on specialty ingredient growth, price mix management and network optimization.

The Southern Cone economy remains challenging, as economic measures lowered consumer disposable income and affected our volumes. For example, the reduction of utility subsidies in Argentina is impacting consumer disposable income and, in turn, our business. We continue our focus on all executable activities of the business.

The Andean countries continue to perform well, as cost discipline expanded margins. We expect the remainder of 2016 to be challenging for South America, and we will maintain a tight focus on cost and network optimization. In the longer-term, we believe the underlying business demographics are positive for the future, and believe we are well-positioned to take advantage of an economic recovery when it materializes.

Moving along to Asia-Pacific, the region delivered [$29 million] (corrected by company after the call) of operating income, up $2 million from last year. Overall volume was up 9% versus last year, and specialty sales were particularly strong in China and Southeast Asia. Our focus on continuous improvement helped boost margin expansion, and our capacity expansion is currently in the process of being commissioned.

Finally, the EMEA region reported operating income of $25 million, up $3 million from last year. Higher volumes and margin expansion offset currency headwinds. In Europe, our broad specialty portfolio continues to perform well and grow. And the Pakistan economy continues to expand, benefiting both our core and specialty volumes.

I'm pleased to now turn the call over to Jack, who will spend time on our financials. Jack?

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

Thank you, Ilene. Good morning, everyone. Let me start by covering the highlights of the income statement.

Net sales were up $52 million for the quarter. The majority of the increase is attributable to more favorable product mix in both our specialty and core ingredients, as well as favorable pricing in South and North America. These factors were partially offset by unfavorable foreign exchange and lower volumes in South America, and from the sale of our Port Colborne, Canada facility.

Gross profit was higher by $39 million as a result of favorable price product mix in both our specialty and core ingredients, and margin expansion as a result of our optimization efforts. Reported operating income was $46 million higher versus last year, while adjusted operating income was $32 million higher.

Reported operating income was lower than adjusted operating income by $3 million. This difference is predominantly related to employee-related severances and other costs associated with the execution of information technology outsourcing.

Our reported and adjusted earnings-per-share were $1.93 and $1.96, respectively. For the quarter, our reported and adjusted earnings-per-share were $0.45 and $0.32 higher than last year's, respectively.

Moving on to the net sales bridge. Our sales of $1.5 billion were higher than last year by $52 million. Favorable price product mix contributed $91 million. That was partially offset by $19 million of foreign exchange headwinds and a volume decrease of $19 million. If you recall, we explained for the past three quarters that, with the sale of our Port Colburn facility, we expected our organic volumes to be down as we shed sales of lower-margin ingredients.

As we look more closely by region, you can see unfavorable foreign exchange affected us in two of our four regions, though to varying degrees. In North America, volume was down 3% and volume grew in APAC/EMEA. Price mix was favorable by 24% in South America, as we continue to price to recover currency devaluations and rapid increases in Brazilian corn costs that occurred over the past two quarters.

As we have explained in our business model, these pricing actions typically require three to six months to take full effect. Price mix was negative in Asia-Pacific and EMEA as a result of the pass-through of lower raw material costs.

Reported operating income increased $46 million and adjusted operating income increased $32 million in the quarter. North America posted the strong results due to more favorable price product mix in both specialty and core ingredients, lower operating costs, due to both Penford and Port Colborne cost savings, as well as logistics savings.

South America operating income decreased by $1 million. Headwinds included lower volumes due to the macroeconomic environment and higher costs for corn, energy, and other inputs. These were partially offset by favorable price mix due to pricing to recover the prior two quarters' currency devaluations and higher input costs, as well as accelerating our network optimization efforts and disciplined cost management.

APAC was up $2 million, while EMEA was up $3 million versus last year. In APAC, volume growth and margin expansion drove higher operating income, while in EMEA, volume and margin expansion offset foreign exchange headwinds. Corporate costs were up due to variable compensation, continued investments in our administrative processes, and other smaller items.

We'll wrap up the discussion of the quarter with earnings-per-share. On the left side of the page, you can see the reconciliation from reported to adjusted. On the right side, operationally, we saw an improvement of $0.29 per share, primarily the results of margin improvement, with a minor amount of other income caused by lapping of a 2015 tax indemnification expense, foreign exchange benefit, and volume.

I do want to take a moment and talk through the margin improvement in more detail, given its magnitude. For the quarter, both our specialty end core ingredients had a more favorable price/product mix. If you recall, we shed some of our lower-margin production with the sale of our Port Colborne facility at the end of last year.

And as we mentioned, last quarter, we continue to optimize our network. Our total Penford acquisition cost savings run rate is expected to exceed $25 million. Additionally, we had cost savings from the Port Colborne sale. Lastly, we had some favorability in our logistics area.

Moving to our nonoperational charges, we recognized a $0.03 per share benefit for the quarter. Our tax rate was lower and contributing a $0.08 per share benefit. The lower tax rate was largely driven by the adoption of a new accounting standard for share-based compensation, as well as a lapping of last year's Mexican peso devaluation effect.

This benefit was partially offset by a higher number of shares outstanding of negative $0.04 per share, driven by the new accounting standard in variable compensation dilution. Additionally, financing costs were a negative $0.01 per share, driven primarily by lower interest income.

I'm going to move fairly quickly through the year-to-date figures. Year-to-date net sales were up $88 million. The majority of the increase is attributable to the addition of acquisition-related ingredients, a more favorable mix in both our specialty end core ingredients, as well as favorable pricing in South and North America. These factors were partially offset by unfavorable foreign exchange and organic volume declines attributable to the sale of Port Colborne and the macroeconomic headwinds in South America.

Gross profit was higher by $134 million as a result of the addition of acquisition-related volumes, favorable price product mix in both our specialty and core ingredients, and margin expansion as a result of our optimization efforts. Reported in adjusted operating income were $132 million and $107 million higher versus the last year, respectively.

The increase in gross profit were partially offset by higher operating expenses, driven by the inclusion of Penford and Kerr business. Reported operating income was lower than adjusted operating income by $17 million. Our year-to-date reported and adjusted per-share were $5.29 and $5.46, respectively. Our reported and adjusted earnings-per-share were $1.20 and $0.99 higher than last year's, respectively.

Moving on to the net sales bridge. Our net sales of $4.3 billion were higher than last year's net sales of $4.2 billion. Volume growth contributed $26 million, driven predominantly by Q1's Penford and Kerr sales offsetting by the reduction of the volume associated with macroeconomic headwinds in South America, and the sale of our Port Colborne, Canada facility. Favorable price product mix contributed $265 million.

These impacts were partially offset by $202 million of foreign exchange headwinds. As we look more closely by region, you can see unfavorable foreign exchange affected us across all four regions, but was most pronounced in South America. Volume grew in North America, APAC and EMEA, and price mix was favorable by 24% in South America as we continued to price to recover currency devaluations and rapid increases in corn costs. Price mix in Asia-Pacific and EMEA was negative as a result of the pass-through of lower raw material costs.

Year-to-date operating income and adjusted operating income increased $132 million and $107 million, respectively. North American operating income was up $112 million, due to acquisition-related volumes, a more favorable price product mix in both specialty end core ingredients, lower operating costs from both Penford synergies and Port Colborne cost savings, and a milder winter than last year, combined with our lower energy rates and logistics savings.

South America income -- operating income decreased by $14 million. Headwinds included foreign exchange, lower volumes due to the macroeconomic environment in Brazil and Southern Cone, and higher costs for corn, energy, and other inputs. These were partially offset by favorable price mix due to pricing to recover currency devaluations and higher input costs, as well as disciplined cost management.

APAC was up $6 million while EMEA was up $13 million versus last year. In APAC, volume and margin expansion offset the effect of the strong US dollar, while in EMEA, volume and margin expansion offset foreign exchange headwinds. Corporate costs were up for the same reason I mentioned for the quarter.

Moving to the earnings-per-share bridge, on the left side of the page, you can see the reconciliation from reported to adjusted. $10 million is attributable to employee-related severance and other costs associated with the execution of the information technology outsourcing; $3 million of employee-related severance costs associated with South America restructuring; $2 million in restructuring charges related to last year's sale of our plant in Port Colborne, Canada; and $2 million of acquisition and integration costs associated with Kerr, and our pending acquisitions in China and Thailand.

On the right side, operationally, we saw an improvement of $1.01 per share, primarily the result of margin improvement with some volume and other income, partially offset by foreign exchange. On margin improvement, as in the third quarter, both our specialty end core ingredients have a more favorable price/product mix. The work on our global network optimization, including our Penford cost synergies and cost savings from our Port Colborne sale also contributed.

Lastly, we had a milder winter with lower energy costs as well as logistics savings. Our nonoperational charges were $0.02 negative year-to-date. Our tax rate was lower, contributing a $0.13 per share benefit, and financing costs were higher by $0.04. The lower tax rate was largely driven by the lapping of the income tax impacts of the devaluation of the Mexican peso during the year-ago period, as well as the adoption of the new accounting standard for share-based compensation.

The impact of shares outstanding was negative $0.08, driven by the new accounting standard and variable compensation dilution. Additionally, noncontrolling interest was a negative $0.03.

Turning to our guidance, we anticipate 2016 adjusted earnings-per-share of $6.95 to $7.10. This guidance excludes acquisition-related integration and restructuring costs, the impact of an anticipated income tax settlement, as well as any potential impairment costs.

For the past several years, we have been pursuing relief from double taxations under the US and Canadian tax treaty. In October of 2016, we were informed that the two countries reached a tentative agreement that would settle the issue for the years 2004 through 2013. We believe the agreement could result in additional tax expense of $23 million to $27 million, which is expected to be recorded in the fourth quarter of 2016. In addition, for the years 2014 to 2016, we expect to record an additional reserve for uncertain tax positions of $7 million to $13 million in the fourth quarter of 2016.

We expect net sales to be in line with last year. We also anticipate volumes to be slightly down from 2015, given the sale of our Port Colborne plant at the end of last year and consumer weakness in South America. However, we expect continued growth in specialty volume.

We anticipate that unfavorable foreign exchange will have a negative impact of $0.15 to $0.20 per share. We expect this impact will be partially offset by incremental pricing.

We expect corporate expenses to be up year-over-year due to variable compensation, continued investments in our administrative processes, and costs to obtain other future efficiencies in our business. For the year, our financing costs are expected to be slightly higher due to higher interest rates on our floating rate debt and our refinancing maturities.

Other adjusted -- our effective annual tax rate is expected to be approximately 30% to 32% versus the adjusted effective rate of 31.8% in 2015. Total diluted weighted average shares outstanding for the quarter were $74 million, and we expect the number to be between $74 million and $74.5 million for the year, given the adoption of the new accounting standard for share-based compensation.

In North America, we expect net sales to be up, but volume to be down from 2015, given the sale of the Port Colborne facility. It is important to keep in mind that a large portion of our sales and costs are based in US dollars, which helps mitigate some of the foreign exchange headwinds.

For the full-year, we expect operating income to be above the 2015 level with improved product mix and margins. South American net sales are expected to be down versus the prior year. We anticipate slow economic activity in Brazil and Southern Cone, and we expect foreign exchange headwinds to persist in Southern Cone.

Throughout the region, we continue to actively manage our costs to drive efficiencies and offset inflationary pressures, and we continue to look at optimization opportunities. We accelerated the closing and consolidation of two of our Brazilian facilities this year from which we expect annual net savings of $7 million. $2.5 million will be recognized this year.

Overall, we expect operating income in South America to be down relative to 2015. Asia-Pacific and EMEA should continue to deliver operating income growth. We expect the APAC business to be negatively impacted by currency headwinds associated with a stronger US dollar relative to last year, but we expect to overcome these headwinds with continued growth in specialty ingredients and good cost management.

We expect our EMEA region to have higher net sales compared to the prior year, with specialty volume growth to offset anticipated foreign exchange headwinds and lower pricing -- prices resulting from the pass-through of the anticipated lower input costs. We anticipate continued growth in the European business, fueled by our specialty ingredients portfolio. However, we expect currency headwinds to partially offset the anticipated improvement. Pakistan is expected to continue its volume growth and drive for continued efficiency gains.

Moving on to cash flow. Our cash provided by operations for the first nine months was $542 million. Our capital expenditures of $197 million were in line with last year as well as our expectation. We expect cash from operations in 2016 to be in the range of $725 million to $775 million, and we expect to invest approximately $300 million around the world in 2016 to support growth as well as cost and process improvements.

Additionally, we issued $500 million of 3.2% 10-year senior notes in September. The proceeds were used to repay $350 million of term loan debt and approximately $50 million of outstanding under our revolving credit facility. And we extended the maturity of our $1 billion revolving credit facility for another five years. As Ilene mentioned, we raised our quarterly dividend by 11% in September.

Importantly, we have a proven track record of both reinvesting and returning capital to shareholders. And we expect to continue this in the future as we concurrently explore M&A opportunities.

That brings my section of the presentation to a close, so now I will turn the time back over to Ilene.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

I'm pleased with our results this quarter. From a strategic perspective, our business model and blueprint for growth are working. Our momentum continues on a positive trajectory and we continue to prepare for the future. Our innovation capabilities and network of Ingredion idea labs enable us to collaborate side-by-side with customers. Together, we create on-trend unique solutions.

Plus, with our global footprint, we can adapt innovations from country to country, customizing solutions to local preferences and tastes. From our foundation of operating excellence, we continue to optimize our cost structure for the future while investing for growth in our specialty business.

Regionally, North America is expected to continue its positive trajectory this year. Asia-Pacific and EMEA are projecting operating income growth, and South America is expected to be down versus last year, given the macroeconomic headwinds. With this year's strategic actions, which include deploying capital for growth, optimizing our global network, enhancing our portfolio through acquisitions, and raising our dividend, we are confident that we will continue to deliver excellent shareholder value.

And now we are glad to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) David Driscoll, Citi Investment Research.

David Driscoll - *Citi Investment Research - Analyst*

Congrats on the quarter, congrats on the year. You guys are on a string of really terrific results here. Can you comment on 2007 -- 2017 North American contracting? Have you finished the liquid sweetener contracts at this point?

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

I'll start off by basically saying we don't comment on contracting. We are happy where we are at right now. But let me turn it to Jack. Any other comments that you would make at this point?

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

Well, David, I guess what I would say is, in general in the industry, we still see very high utilization rates in that 85 to 90 -- low 90 type of percentage operating levels. And so if you think about that, and you kind of say the market is very similar to last year in terms of utilization levels, so I would expect -- you know, I'm not -- we don't comment on 2017 specifically, but like I would say that the market is kind of in the same position as it was previously. And so we are seeing a fairly tight market.

David Driscoll - *Citi Investment Research - Analyst*

Jack, can I just debate that slightly? So the Port Colborne plant sale occurred at the end of last year. Did that happen in time to really affect last year's contracting this time last year? I don't think it did, but I'd really like to hear you guys talk about the impact of that plant and when it was sold, and in effect it was taken out of play.

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

Yes, David, I guess I would say that in closing -- we closed the transaction at the very end of last year because we had to fulfill our contracts for last year as well. But we really announced it significantly before that. And so I think the news was in the marketplace at that point in time.

So I think mostly the facts, they just haven't changed that dramatically from last year, and demand has stayed strong throughout the year. So, I'm still very comfortable with where we are at in terms of industry supply/demand utilization rates.

David Driscoll - *Citi Investment Research - Analyst*

On the network optimization, will that have any benefits, any additional benefits incremental to 2016? Or is it by the time we get through the fourth quarter here, we'll have seen all the benefits from the network optimization?

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

If you think specifically about North America, obviously we've lapped the Port Colborne closure at that point in time, but you know even in North America, we continue to look at optimization, optimization with respect to the Penford acquisition. And so we continue to look at tightening up the market in terms of putting facilities into the most cost-effective locations and changing around our network there.

In South America, I would say that we also have the advantage of having consolidated two of our facilities in South America, and Brazil specifically. So we still have the four very strong operating facilities in Brazil. But now we are recognizing probably in this fourth quarter, a couple -- $2 million to $2.5 million of advantage in the fourth quarter of that consolidation.

And in addition, we'll have the remaining -- well, the total for the year would be $7 million on a run rate basis, so it would be like $5.5 million, $4.5 million type of range, $5.5 million type of range in terms of next year optimization. But you know it is a continual process, I would like to highlight too. We are continuing to review our plans around the world and saying how can we optimize them?

We're kind of excited because we started up some of our new specialty capacity around the world, that allows us to ship to different locations, and you know we are just commissioning the one in -- as Ilene mentioned, we are commissioning the one over in Asia right now. And so that allows us to fill out some of our portfolio to meet some of that unmet demand as well. So, I think we are feeling pretty good about our whole network around the world.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

The only thing I would add is, when Jack mentioned the optimization post the Penford acquisition, we obviously are focusing on optimization of utilization in the industrial business. So while we work on food and sweetener and ingredient solutions, there is obviously optimization going on in the industrial side from completing the Penford acquisition, which is really in the two-year synergy stage. We're just finishing that up.

David Driscoll - *Citi Investment Research - Analyst*

Can I sneak one more in? Just on South America. You mentioned a lot about the foreign exchange headwinds and slow economic activity, but I don't hear enough about the difficult corn crops that we saw there, and I'm really curious that if we were to have a return to normal corn crops in Brazil and an increase in Argentine corn production in 2017, would that be of substantial benefit to your operations? And if not, kind of why?

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

Let me start with Argentina, because it's probably the easiest of the two. And part of our -- when we're looking into 2017, obviously the plantings are much higher in Argentina than they were previously.

From a structural perspective, as you know, the governments have taken off a lot of the export subsidies that were on corn and things like that, which puts a little bit more of pricing into that domestic marketplace, but it will be very reflective of, I would call, international pricing at this point in time.

And so obviously, if the core prices stay relatively low in Argentina, since most of the pricing is reflected -- like our pricing of our end product is reflective of sugar type of pricing, and sugar prices were up slightly, as well as it's starting to move in that direction in Argentina in terms of getting our prices back in line with world sugar, yes, I would say that there's -- should be some benefit associated with that component.

We do have some wide devaluations and the inflationary pressures in Argentina because it's always a difficult country to call. And when I say Argentina, I'm really talking about Southern Cone.

The other large one you mentioned is Brazil. And I think you've seen our results right now is that we've kind of passed through, it takes us the three to six months in terms of passing through those higher corn costs. And they really started to accelerate at the beginning of this year as you know, as they exported a little bit extra too much corn out of the country, and there was a shortage within the country.

And so I would say that we've kind of got those prices in place at this point in time. So if prices fall, there's at least still some lag in terms of the adjustments, the same as it was with the rise. So that three to six-month type of timeframe. But that economy kind of balances very closely. We've got it in a good position where it's basically a pass-through type of area. And we don't really think there's any major impact on corn year-to-year type of thing.

David Driscoll - *Citi Investment Research - Analyst*

Thank you.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Welcome.

Operator

Sandy Klugman, Vertical Research.

Sandy Klugman - *Vertical Research Partners - Analyst*

So we are obviously seeing near-term headwinds in both Brazil and Argentina, but has there been any meaningful change in how you are thinking about the demographics or the long-term potential within the region, given the shifts we've seen in the political backdrop?

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

This is Ilene. The answer is no. We continue to be excited about the long-term demographics. We don't know when it will turn, but in terms of the rise of the middle class, the demand for healthy solutions -- in fact, I think that the specialty ingredients, I've seen some good green shoots of growth in Brazil and even in some of the other areas of South America. Colombia, where the consumer wants healthy food; I always talk about the rise of dairy, other type of ingredients solutions. So, we believe that it eventually will come back and we continue to be excited about the long-term demographics.

Sandy Klugman - *Vertical Research Partners - Analyst*

Okay, great. Thank you. And then with regard to the specialty business and your six springboard growth platforms, could you comment on where you are seeing the greatest traction or longer-term potential?

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Well, when we think about the different springboards, which are really focused on these consumer trends, of course we are a leader in texture. And so we continue to put together solutions and texture, as we talk about, have many different raw materials from corn to tapioca. And we are excited about our potato being gluten-free and non-GMO. And then even our recent announcement of buying the rice company in Thailand, also gluten-free and non-GMO.

So we're seen as this texture leader. So that one, of course, is something that we've been a leader in and we continue to be excited about it.

I think the other one that certainly I love to focus on is the one where we talk about the Clean Label aspect, our Novation. And this is where the trend in Europe has been very much focused on healthy eating and labels that are simple. And this has really come over to North America now.

And so we talk a lot about the consumer and over 60% of them want a simple label. They want to know what's in their ingredients. It's driven by the millennials, the same size as the baby boomers. So we call this our wholesome springboard. But really it's all about simple and healthy ingredients.

And some of the other springboards like nutrition is one where we see a lot of opportunity to grow because the consumer wants fiber. They want -- they are interested now in having protein, vegetable protein in their pasta, and other type of baked goods and other type of ingredients. So we see that the consumer is interested, and therefore work with our customers on ways to get these healthy ingredients into our different products.

Sandy Klugman - *Vertical Research Partners - Analyst*

Thank you very much.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Welcome.

Operator

Rob Moskow, Credit Suisse.

Rob Moskow - *Credit Suisse - Analyst*

Congratulations again. And Ilene, is there anything more you can tell us about the growing demand for specialty in Brazil and Colombia? I know it's just very early stages, but there's not much in terms of specialty sales in those regions now. Do you have any idea like what that could turn into at some point? Or is it just way too soon to tell?

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Well, I think it is too soon. And of course they are growing from a small base, so I get excited about higher growth rates. But if I look at a place like Mexico, and Mexico was an area where specialty wasn't growing, and now as the population grows with the growth of the middle class, people want to eat more healthy, we are seeing an opportunity to bring our solutions from other parts of the world, and to localize for local tastes and ingredient -- texture ingredient, let's say for yogurt, and to be able to drop that solution in to those products and have a good consumer acceptance.

So, I look at a place like Brazil when I see some of that happening, that I see that can follow the growth rate that we've seen in Mexico. And the food side certainly, we've been excited about what we've seen from the Mexican consumer. And of course Colombia has been a great economy. And in terms of the GDP, it's one of those areas where this year, it will be over 2%. I think it's something like 2.2%.

And the consumers there are -- again, I was there in June at a meeting, and we really saw a lot of demand for healthy ingredients. The use of tapioca, which is grown in Colombia -- it's gluten-free, it's non-GMO, it's used in cheese bread -- would be an example. And the consumers' demand is growing there.

Rob Moskow - *Credit Suisse - Analyst*

Okay. And just a follow-up for Jack. I know it's too early to talk about 2017, but given the trends in your business, I'm having trouble seeing why you wouldn't be able to deliver just kind of like your normal algorithm for 2017. I'm not sure if that's fully baked into the market.

Because I think there's an assumption out there that your business did so well in 2016, it provides a tough comp. Can you give us just kind of like the building blocks, like bigger building blocks of puts and takes?

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

Sure. Robert, I think you actually articulated it very nicely. If you think back to the algorithm where you have your volume growth, we still see the specialty volume driving that with some smaller -- in terms of the core ingredients in Mexico and Pakistan, continuing in that vein. So that's in that 2% to 4% type of range.

And then if you really think through on the margin expansion, we -- don't forget, these numbers are five-year numbers. And so we had said that our margins would expand by the 2% over a five-year period due to the mix. And we are seeing that trend continue going into next year as well.

And then we continue to really focus on our operating expenses so that -- because we are in so many different countries. We continue to spread those operating expenses over a much faster growing margin type of improvement to get the other 2%. So that gets you in that 6% to 8% range, and then the rest just really depends on how we deploy the free cash flow, which comes down to what's the M&A pipeline and what's the other components seeing, obviously we can buy back shares, rather components to deploy that cash flow.

But you know, in that 6% to 8% range, it's probably we're kind of tracking along that line in our five-year algorithm. And while it may be plus or minus on -- in any given year, I still think we are tracking very nicely in those categories.

Rob Moskow - *Credit Suisse - Analyst*

That's great. Thank you so much.

Operator

Farha Aslam, Stephens.

Farha Aslam - *Stephens Inc. - Analyst*

And also congratulations on the quarter. I'm going to focus on South America because I need more help there. Seasonally, December is a stronger quarter for South America, but the corn availability is really tight. So if we had to look sequentially December to September, should we think of it up, down? Kind of help on the EBIT line for South America would be appreciated.

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

Well, you know, if you think about the quarter, obviously seasonally, it's the summer months -- we're starting into the summer months down there. So, it's directionally, you are absolutely correct.

I think where we have guided -- even in our guidance range, one of the reasons why we left the $0.15 there is Argentina is one of the ones -- or Southern Cone, I'll call it, is the one that we are having challenges calling, because it's really a volume-driven item there. We are seeing pricing correct.

We've seen corn costs coming back in line. But really it's that disposable income of the consumer, and will they be at the beach this summer and things like that, and actually consuming the goods and services? And that's the one that we've left a little bit of movement in our range.

We do expect it to be kind of flat to down for the quarter as well. Brazil seems like it's kind of coming back. It's got the real strength, and as you know, it's around that [3.2%], which is a little bit improved from where we anticipated it earlier in the year and things.

But we haven't really seen a robust volume or anything in Brazil. I think the breweries have been kind of flat to down slightly in the marketplace. And so we are still kind of in that bouncing -- I hate to say bouncing along the bottom of South America, but that's kind of how we are still looking at it. We are waiting for that bounce up, and I'm not quite ready to call that at this point in time.

Farha Aslam - *Stephens Inc. - Analyst*

And then looking longer-term at South America, while timing is hard to call, it looks like the economies are stabilizing. You are looking at much more available corn going into next year. You have the benefits of your restructuring actions. What do you think the earnings power of South America is today compared to -- I mean we've had a range of anywhere between $100 million to $198 million for the last four years.

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

You're correct. And 2012 was the peak at around almost a $200 million type of range. This year, we are probably someplace below $100 million type of range. And so I understand that that is a fairly wide range. I would say that when I think about South America, when we got up to that $200 million, Argentina was probably a little bit too high, because it was earning -- and I say Argentina, I should be saying Southern Cone, because it's the group of countries there. And it's -- it was in and around that $100 million range.

And I don't think we'll get Southern Cone back up to that $100 million. We've said it should be getting back up to earning its cost of capital and we'll continue to drive to do that. So it should be in the $65 million type of range at the maximum type of idea. And so that came off a little bit.

But on the other side of the equation, we've got our specialty growth kicking in. And so that gives us some margin as well. And Brazil, I think is, the core business will just return back to its normal state. And the Andean region continues to grow. So I don't want to just throw out a number in terms of a target out there, but at $200 million is a stretch. Something below that is probably in the works and it's just a matter of how quickly we can get there.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

And if you look at the IMF forecast for GDP growth in Brazil, I mean, it does trend positive next year. Right now it's at 0.5%; in 2018, 1.5%. So the IMF obviously is looking for economic growth to turn around sometime next year.

Farha Aslam - *Stephens Inc. - Analyst*

So next year in South America, we can see that as a growth driver for your business, just that recovery in South America?

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

Well, I think there is a lot of variables, Farha, and I think we'd prefer to wait until we give the guidance for next year to really give anything even on the regions. We are always optimistic on South America but we want to get a little bit closer to seeing how the recoveries are taking place, and what other dynamics are in place in the different countries, before we give you any guidance on any specific region, okay?

Farha Aslam - *Stephens Inc. - Analyst*

Understood. Thank you.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Welcome.

Operator

Ken Zaslow, BMO Capital Markets.

Ken Zaslow - *BMO Capital Markets - Analyst*

So let me just talk about the specialty division -- the specialty products. Can you talk about, in the next two to three years, how much do you think -- it seems like now you are really kind of getting to the point of critical mass in this specialty business. Is there a potential that we could actually see margin expansion beyond what the North American cost savings and the North American strong utilization rates are? Can you talk about what contribution you think that in isolation would be within the next two to three years on the margin side?

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Well, I'll start off and then pass it to Jack. But if you think about our long-term algorithm, we said that we believe that we could grow the specialty to 30% of our sales by 2019, and obviously last year, we were at 25%. So we talk about moving along that journey, and that the growth of specialty will help drive the margin expansion and the algorithm of 2 percentage points, which obviously, this year has gone well.

So we are getting a better mix and then we are getting the throughput. You know when you talk about critical mass, I mean, I think at 25% last year, we were at $1.5 billion. And so we believe that we are at a minimum scale in terms of it, but really what it's all about is moving with these consumer trends and growing to that 30%. And these trends are accelerating in terms of the consumer wanting the healthy ingredients and the different configurations.

So, we have been adding capacity, as we announced for some of our specialty products in Indianapolis and in Thailand. We talked about it coming onstream. So, there is no reason why it shouldn't continue to grow along those demand trends.

Ken Zaslow - *BMO Capital Markets - Analyst*

But as -- I'm sorry -- but as you add capacity and you continue to R&D behind it, is there margin accretion? Or do you need to get to a certain level where not the capital investment in R&D spending behind it kind of settles into a more normal level, where you actually get the margin expansion, right? I mean I get it on the gross margin, but wouldn't it be on the operating margin not yet that accretive? Or maybe I'm wrong and it's fair. I'm just trying to figure out the critical mass, and is there a point in time that you are spending kind of levels out that you get the operating margin enhancement?

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Yes. Well, I would say when you think about the fixed cost spreading over the specialty, I think I may have given this example before -- you need one analytical lab. We put one in a year ago that had been outsourced. There is different marketing costs. So it depends on the nature of the fixed cost.

So you are right, you do -- you don't need the second analytical lab, but as you grow with the different consumer trends, you need to have the appropriate focus with marketing. As an example, protein in -- vegetable protein would be an area that we would be growing. And so, by having these idea labs around the world -- we have 24 of them -- we use them to localize these solutions, but it is true that we would add selective investments either in the idea labs or in our central idea lab in Bridgewater, to drive that. So it's a combination of some of it is very fixed and some of it is variable.

Ken Zaslow - *BMO Capital Markets - Analyst*

Okay. I'll take it more off-line. Thank you.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

All right. Okay.

Operator

Akshay Jagdale, Jefferies.

Akshay Jagdale - *Jefferies LLC - Analyst*

Congratulations on another good quarter. Can you talk a little bit about a little more details on the Penford deal? I mean, obviously it seems like it's been a real home run for shareholders. When you first announced the deal, I think you said it was going to be $0.13 accretive. It looks like it's, at current rates, at least double that.

But you mentioned exceeding the $25 million synergy target that you have out there right now. Can you just talk about that -- what the source of those synergies are? And when that business was standalone, I mean, it had an ethanol piece and it had a couple of segments. So can you give us some sense of core versus specialty and how that's doing?

Because I believe they had some specialty products that were close to being commercialized. I'm wondering if any of that has materialized, and if it's included in the synergy number by any chance?

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

Yes, I think when we look at the Penford acquisition, it's been very successful for us. And looking back at the run rate of our synergies, for example, the first step was to take out some of the public company costs, the administrative costs. They went extremely well, but that was executed very quickly and have gotten into our results as rapidly as possible.

And we put the integration teams together to really focus on how we could drive the growth of the businesses into the different segments, as well as the manufacturing platform. And I would tell you like we could talk about over $25 million in synergy costs. And part of that is because of the fact that the businesses are almost fully integrated at this point in time, where it's getting harder and harder to actually pull out what costs are where.

But what we're really seeing is -- I commented earlier about some of our logistics costs, where we've taken out some of the costs associated with even supplying to our customer base because of our network and adding a facility there. We've talked about some of the different components in terms of how we are taking some of the product at Cedar Rapids and moving them to Kansas City and be other locations in our network, where they can be produced more efficiently and effectively to supply that -- those areas.

So, the integration actually went extremely well. And then on the other side of the business -- I'm going to flip it over a little bit -- because you know, the potato starch business has been one of those ones that added great value to our customers as well, because essentially it allowed us to come in to that gluten-free element with potato starches. And that business has performed up to our expectations, if not above.

And so it was kind of mixed very nicely in with our texture profile. And so you know I think when we really look at that business, at that acquisition, is when it kind of demonstrates that we are able to acquire businesses and integrate them in well, and get the synergies and continue to drive them.

And Ilene has mentioned in the past that even years after the National Starch acquisition, we are still reconfiguring our network and things to make minor tweaks to that -- those -- where those products were being produced, to drive cost savings and efficiencies. And so it continues for a long period time.

Ilene, do you want to add anything?

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Well, the thing -- what I would add, Akshay, is that when you talked a little bit about some of the commercialization of the new products, what we call revenue synergies which we never articulated a specific number, those are just starting now, so they would not be in that $25 million-plus. Those are much more cost synergies. And revenue synergies take longer.

And so they would just be starting right now, and we'll continue to drive those over the next few years. But that is an exciting arena to have different material, raw material capabilities to design products, both food and non-food for our customers. So, that would be what we are working on now.

Akshay Jagdale - *Jefferies LLC - Analyst*

And just two follow-ups. One on acquisitions again. So can you give us a sense of the -- what is your -- how would you characterize the environment today? I know historically you've said you'd like to do two or three several-hundred-million-dollar deals rather than a big transformative deal.

But overall, M&A activity seems to have slowed a little bit last six months in the food space. Can you just comment on what you are seeing out there, just the environment, how you would characterize the environment? Obviously you've been very judicious and selective, which we appreciate. But if you can just give us a sense of what you are seeing, that would be helpful.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Sure. You know the bolt-on market, which are these smaller deals, I think continues to be very robust in that, in terms of ability to look at the different deals. And I think what I've said before is, look, we look at divisions of larger companies, and so obviously you look at how -- what price you'd have to pay to create value. And so we've been very disciplined about that.

And at the same time, we continue to knock on a lot of doors of family companies. Some of them are in Europe. Some of them are in North America. Obviously, we announced two particular deals in Asia this year that we are in the process of working on the final steps of closing. But I would say that these families continue to be willing to engage in discussions. And it's all about value for them and value creation for us.

And we are trying to match those two and come up with a scenario where there is a product line or a raw material that will, as I said before, make us more important to our customers. And so it's matching that value that they expect, or would like, with what we are willing to pay and how we are going to create value and have the plan.

And what I've always said is, we've got to have the plan. There is a cost synergy plan and there is a revenue synergy plan. And with most of these that we are looking at, it's really focused on enhancing the product line, which means you've got to grow with customers and you have to have a plan. And so we spent a lot of time with our customers, understanding what the consumer is looking for, the unmet market needs, and how making those acquisitions that we would have to pay for, how do we create value for their shareholders by making that happen?

So we continue to be excited and spend a lot of our time working through the world. Many of us are dealing with those situations. And this isn't just auctions. I mean we try to be -- to get to know these companies, and they know us over time. And we have a track record of valuing people and technology. And so that's really what we think is our competitive advantage, not just a big checkbook but a great balance sheet, but an ability to really integrate the technology.

Akshay Jagdale - *Jefferies LLC - Analyst*

And just one last one on contracting. I know somebody -- you were asked this question before, but from our side, I mean, anecdotally, we're hearing contracting season is being conducted and I think completed even much earlier than historical timing, which is indicative of a tighter market. And then some of the price indications are also showing reasonable -- or significant, I must say -- price increases, which would point to margin expansion. So, can you just generally comment on whether that directionally is what you are seeing in the market as well?

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

Akshay, I'd say the same as what I commented earlier. Basically is this, utilization has remained fairly solid in the industry. And so I would say that contracting always has its own rhythm at -- into any given year, but whether that's fast or slow, sometimes reliability of supply into our customers is more important than pricing and vice versa.

And so I would say that, directionally, I think it all depends on which market you are looking at. Because the markets vary widely in terms of our product categories. I'd like to highlight too that we are no longer like an HFCS market -- that's less than 10% going into the beverage segment.

And so I know that a lot of people think about that as our marketing campaign. But really, to a large extent, our go-to-market extends well past those type of sweetener type of products. And so they are different in nature, and they will continue to contract and they still contract on an annual basis. And it's in process.

Akshay Jagdale - *Jefferies LLC - Analyst*

Perfect. Thanks so much. I'll pass it on.

Operator

Adam Samuelson, Goldman Sachs.

Adam Samuelson - *Goldman Sachs - Analyst*

A lot of ground has been covered, so two quick questions from me. First, on the fourth quarter, it seemed like most of the guidance increase for this year reflected the 3Q performance, and that there is -- it looks like some embedded deceleration in margin expansion in the fourth quarter, especially in North America. And I wanted to see if that view is fair?

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

Yes. I think as -- obviously, as we look at quarters, that's why we give annual guidance all the time, because you're never exactly sure how the quarters will lay out and things like that because the way that we lay in the corn and a number of different variables on the fixed-price contracting.

So I would say that -- like I say, it is more or less in that vein where the guidance is kind of coming into where the consensus forecast are for the fourth quarter. I think we are very pleased with where we are at with our guidance range at this point in time.

Adam Samuelson - *Goldman Sachs - Analyst*

Okay. And then just a second -- a follow-up question on capital. Wondering, given the magnitude of earnings growth both this year and last, the cash flow you've been generating considerable free cash flow, haven't done a lot on the acquisition front this year.

How should we think about the only 11% increase in the dividend, and the fact that the share creep that you experienced here to date, well, why not at a minimum offset dilution with repurchases? And why not consider a more sizable dividend increase to match the earnings growth that you've seen the last couple of years?

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Well, I'll start off and then see if Jack wants to add anything. But when we think about the use of cash, it's always about driving shareholder value. And so of course the priority, the first priority is organic growth. And so we fund our businesses for both maintenance and productivity and growth. And, as we've announced, we've been implementing this growth capital on the specialty side.

And I would say the other -- the next priority is always about M&A. And again, we are going to find the right value-creation that I talked about before in matching what the buyer -- what we as the buyer are willing to pay versus what the seller sees as terms of the value and making sure there's a good fit there.

And so we continue to look for that. And so the dividend -- you know we raised that dividend 11% because we felt that obviously having a steady dividend growth was a message in line with really our goal of the 25% to 30% payout, which is really what was driving that number.

And then we look at share buybacks if they will create value and we don't have better uses of cash earlier on. So those are the priorities how I think about it.

Jack, I know that you think a lot about that.

Jack Fortnum - *Ingredion Incorporated - EVP and CFO*

You know, it's interesting, because I always think that we really position to the Company for the future as well, where we are getting consistency in terms of our dividend increase, where we are very consistent in terms of our capital expenditure program, where with our growth, we'll obviously be continuing to invest [300-plus] in it.

Share repurchases, we look at opportunistically a little bit from the vantage point of we want to buy back our dilution longer-term, and I think we are tracking that, because we did make the correction a few years ago where we bought back significant shares. And so I actually think that we are positioned very well for the future in terms of our deployment, and it allows us the flexibility -- as you know, we just did the debt refinancing and things.

And so really, our balance sheet is all set up really to allow us to do any size acquisition, continue to return money to our shareholders on a regular basis, and really kind of keep it all in balance as we move forward.

Adam Samuelson - *Goldman Sachs - Analyst*

All right. Thank you very much.

Operator

Arthur Reeves, Societe Generale.

Arthur Reeves - *Societe Generale - Analyst*

Thanks for the question. Could you tell me which areas of the world you are looking to make acquisitions in? And do you have a favorite region? If so, maybe you could say why?

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Well, we look at all regions. And we are looking for really technology and people that can help us drive our business. Now, in the past, if you look at when we bought National Starch, that was a global business. Penford was more North America-based; Kerr, North America, but then, of course, the two that we announced earlier this year in Asia.

Certainly Europe has quite a few businesses that we are looking at, that are -- more of them are privately owned. Some of them are divisions of larger companies. What you hear absent is South America. We actually have some alliances on one of the particular raw materials with the Chilean company. We've looked at a couple.

But I would say that certainly every region is rich with opportunities, but that our focus has been obviously more on North America and Asia. But I would -- I'd throw Europe in there as a real possibility because of the technology. And the companies may be based in Europe, but we look for companies that have capabilities in more than one region.

And so they may be based in Europe, but they may have opportunities to help us expand in North America, Mexico. And then we could take our global network and bring the technology to Asia and South America.

Arthur Reeves - *Societe Generale - Analyst*

Thank you.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Welcome.

Operator

And with no further questions, I'll turn it back to the Company for any closing comments.

Ilene Gordon - *Ingredion Incorporated - Chairman, President, and CEO*

Okay. To just really quickly sign off here, I want to reiterate our confidence in our business model, our strategy, and our long-term outlook. We remain keenly focused on value creation and delivering that value to shareholders. So, that brings our third-quarter 2016 earnings call to a close. And thank you again, everybody, for your time today. Thanks.

Operator

Ladies and gentlemen, that does conclude your conference. Thank you for your participation. You may now disconnect.