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INGR - Q4 2018 Ingredion Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 05, 2019 / 1:00PM GMT

OVERVIEW:

Co. reported 4Q18 net sales of $1.426b, reported operating income of $158m and reported EPS of $1.36. Expects 2019 adjusted EPS to be $6.80-7.50.

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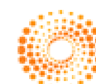

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Ingredion Fourth Quarter 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Heather Kos. Please go ahead.

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

Good morning, good afternoon and good evening, and welcome to Ingredion's Fourth Quarter 2018 Earnings Call. Joining me on the call are Jim Zallie, our President and CEO; and Jim Gray, 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 earnings 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 8-K.

During this call, we also refer to certain non-GAAP financial measures, including adjusted earnings per share, adjusted operating income, adjusted effective tax rate and adjusted cash flow from operations, which are reconciled to U.S. GAAP measures in Note II, non-GAAP information, included in our press release and in today's presentation appendix.

Now I'm pleased to turn the call over to Jim Zallie.

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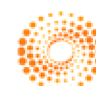

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James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Thanks, Heather, and welcome to everyone joining us today. Let me start with a discussion of our fourth quarter and what was most relevant: The market dynamics in North America. As we have discussed in prior calls, we have been strategically focused on positioning our business towards the shifts in consumer preferences and a changing customer landscape.

Operating income in North America was down for the quarter, impacted by lower sweetener demand, higher supply chain costs and commodity margin pressures. In response, we continued to make progress against Cost Smart, actioning $11 million of run rate savings, exceeding our $5 million target for the year. We successfully retained our West Coast customers, having reduced our U.S. high fructose corn syrup manufacturing footprint with the cessation of operations at our Stockton plant. And we continued to invest in our specialties growth platforms with our decision to diversify our portfolio into plant-based proteins with the announced acquisition and retrofitting of a plant to produce pea protein and the formation of a new joint venture with Verdient to produce a range of pulse-based protein ingredients. In addition, we enhanced our sugar reduction formulating capabilities by building new processing capacity in Mexico to produce the rare sugar, allulose.

Moving outside of North America, we continue to experience the effects of foreign currency devaluations, primarily in Brazil, Argentina and Pakistan. In response to market conditions and foreign currency devaluations, we are taking a series of pricing actions to mitigate currency impacts. In addition, we continue to structurally reduce our cost base, an example of which is the extension of our shared service capabilities into Latin America.

To highlight the quarter 4 results. Ingredion volumes were up 2%, driven by specialty growth. North America and South America operating incomes were down. Asia Pacific operating income was up, given pricing actions to offset the extraordinary rise in tapioca costs that we've experienced throughout the year. EMEA operating income was down slightly, given a lag in pricing to offset the Pakistan rupee devaluation.

During the quarter, we continued to deploy cash for shareholder value creation with nearly 4.25 million of share repurchases.

For the full year, our volumes were up 1%, driven by specialty volume growth. Our specialty portfolio grew to 29% of total net sales, driven by continued demand for ingredients from our on-trend specialty growth platforms, such as clean and simple ingredients, sugar reduction and specialty sweetener and specialty texturizers.

I am pleased that our team is finding attractive investment opportunities to further broaden our specialty ingredient portfolio. In addition to the pea and pulse protein and sugar reduction investments mentioned earlier, we also announced $60 million of investments in Thailand and China to support additional specialties growth by expanding our modified and clean label starch capabilities in tapioca, waxy corn and rice. And we continued to deploy cash for shareholders with our fourth consecutive annual dividend increase announced in September and a total of 5.8 million of share repurchases during 2018.

Now moving to North America. Net sales were slightly down for the year. Volumes were flat, driven by increases in specialties and gains in Mexico, partially offset by lower U.S./Canada sweetener volumes. Higher freight cost impacted price/mix. Full year operating income in North America was $545 million, down 17% from last year. As we've mentioned in prior calls, our production costs were higher due to rebalancing of inventories and starch production across our network as well as operational inflation. We also continued to experience the residual impact of commodity margin pressures on our business.

In South America, net sales were down for the year due to significant foreign currency devaluations. However, the team managed through multiple price increases to offset higher raw material costs due to a smaller crop in Argentina and the impacts of ForEx declines. This resulted in a 13% increase in price/mix. Full year operating income was $99 million, up $18 million from the year ago period due to improved operational efficiencies and the lapping of the 2017 Argentina work stoppage. We continue to monitor the macroeconomic environment in Argentina and are cautiously optimistic about economic growth in Brazil. Despite the challenging macroeconomic environment in South America, it is worth noting that for the second consecutive year, our Ingredion team in Brazil was acknowledged for making our Brazilian business 1 of the top 150 best workplaces in the country.

In Asia Pacific, all year, our team has worked to mitigate the impact of a short tapioca crop and rapid rise of tapioca costs. For the year, the team has been able to work with customers to partially pass through our raw material cost increases. Net sales show a 9% increase for the year, driven

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by a 4% increase in price/mix across the region. The region delivered $104 million of operating income. And although down 10% versus the prior year, quarter 4 operating income was up 15% versus the same quarter last year.

Finally, the EMEA region delivered 5% net sales growth due to strong European specialty growth and a great effort by our Pakistan team to manage price increases to cover higher corn costs and a devaluation of the rupee. 2018 operating income was $116 million, up 2%.

Now let me hand off to Jim Gray, who will discuss our financial performance. Jim?

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Thanks, Jim. I'll start by covering Q4's performance. Net sales of $1,426,000,000 were down slightly for the quarter. Gross profit margin was lower by 260 basis points, driven primarily by weaker performance in North America. Reported and adjusted operating incomes were $158 million and $177 million, respectively. Reported operating income was lower than adjusted operating income by $19 million. The difference was due to $18 million of restructuring charges associated with our Stockton, California facility, while the balance was attributable to our Cost Smart SG&A initiatives. Our reported and adjusted earnings per share were $1.36 and $1.61, respectively.

Q4 net sales of $1,426,000,000 were $11 million down from the same quarter last year. Unfavorable FX of $98 million was primarily attributable to currency devaluations in Argentina, Brazil and Pakistan. Volume increases contributed to $28 million of sales increase as well as a $59 million increase from favorable price/mix.

In North America, volume was slightly up year-over-year, driven by gains in Mexico, offsetting expected lower sweetener syrup volume as we ceased operations at our Stockton facility. Price/mix in North America was down, given higher freight costs and commodity margin pressures.

In South America, foreign exchange devaluation was the largest driver of the year-over-year net sales decline. Volume was down 7% due to the impacts of the Argentina recession on beverage sales and weaker brewing sales in Brazil. Price/mix was up 22% as our teams took price increases to pass through higher raw material cost and recapture some of the foreign exchange impact in Argentina and Brazil.

APAC had specialty and core volume growth, and price/mix was up, given tapioca pricing pass-through. EMEA had strong volume growth, driven by specialties in Europe. And Pakistan delivered positive net sales growth, driven by price increases to offset the fourth quarter rupee devaluations.

For the quarter, reported and adjusted operating income decreased $44 million and $32 million, respectively. North America operating income decreased $25 million due to higher supply chain costs, continued starch inventory rebalancing and lower sweetener volumes. South America operating income was down $5 million, driven by the impacts of the Argentina recession on net sales versus the year-ago period and impacts of currency devaluation on applied hyperinflation accounting. Asia Pacific was up $4 million, driven primarily by higher price/mix, given pricing pass-through of tapioca costs and higher volumes. EMEA was down slightly due to the impacts of unfavorable Pakistan foreign exchange and higher corn costs, offset partially by favorable specialty and core volume.

Corporate cost were higher by $5 million for the quarter, given further investment to optimize our global processes via our Cost Smart initiatives, a continued investment in R&D to drive specialties growth.

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 a decrease of $0.30 per share, primarily driven by a margin decline of $0.23 per share attributable to North America and partially offset by $0.07 per share in volume gains. Unfavorable foreign exchange was $0.15 per share.

Moving to our non-operational items. We saw an increase of $0.18 per share for the quarter, largely driven by favorable tax and lower average shares outstanding, partially offset by higher financing costs. Financing costs were a $0.03 per share decrease, driven by a higher rate debt balance as compared to a-year-ago period. Lower adjusted taxes contributed an $0.11 per share benefit, primarily driven by U.S. tax reform. Shares outstanding contributed a benefit of $0.10 a share.

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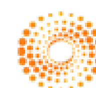

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For the full year, the company delivered $5,841,000,000 of net sales, which was up slightly from 2017. Reported and adjusted operating incomes were $703 million and $767 million, respectively. Reported operating income was lower than adjusted operating income by $64 million. The difference was due to $49 million of restructuring charges associated with our Stockton, California facility; $11 million of charges associated with Cost Smart SG&A initiatives; and $4 million of other restructuring costs. Our reported and adjusted earnings per share were $6.17 and $6.92, respectively.

As we look more closely at net sales by region, you can see unfavorable foreign exchange which totaled $198 million for the year, affected most prominently in South America led by the Argentine peso and Brazilian real devaluations. Volume growth for the year was positive $76 million. Volumes were up in Asia Pacific and EMEA, and North America volume was flat with increases in Mexico and specialty ingredients, offset by lower U.S./Canada sweetener volumes. In total, the price/mix increase was $131 million, up 2%. Price/mix was down slightly in North America due to higher freight cost and lower commodity values. In other regions, price/mix was up due to pass-through of raw material costs and FX.

Full year reported and adjusted operating income decreased $133 million and $111 million, respectively. North America operating income decreased $109 million due to higher supply chain costs, continued starch inventory rebalancing, lower sweetener volumes and commodity margin pressures. South America operating income was up $18 million, driven by our more competitive cost structure in Brazil due to operational excellence initiatives and in Argentina due to our new labor agreement and organizational restructuring. Asia Pacific was down $11 million, driven by higher tapioca costs. EMEA was up $2 million, with specialty and core volume growth more than offsetting foreign exchange headwinds in Pakistan. Corporate costs were higher by $11 million, given the same reasons impacting the quarter.

Moving to earnings per share. Operationally, we saw a decrease of $1.08 per share. Challenges in North America costs and higher tapioca costs in Asia were primarily contributors to a margin decline of $1.15 per share. Volume increases contributed $0.34 to help offset the decline. Unfavorable foreign exchange of $0.29, primarily in the second half of the year, was driven by currency weakness in EMEA and South America.

Moving to our non-operational items. We saw an increase of $0.30 per share for the year, largely driven by a lower tax rate and reduced shares outstanding. Adjusted taxes were a $0.27 per share benefit, driven by the impact of the reevaluation of the Mexican peso on the U.S. dollar-denominated balances in Mexico, a reduced valuation allowance on the net deferred tax assets of a foreign subsidiary and U.S. tax reform. While shares outstanding contributed a benefit of $0.16 a share, these benefits were partially offset by higher financing costs of $0.12 per share, which includes the impacts of Argentina's hyperinflation accounting and a higher debt balance.

2018 cash provided by operations were $703 million. This was lower than expected due to a decision to curtail use of customer financing programs, primarily in Mexico, given the rising cost of these programs due to higher short-term interest rates. Capital expenditures of $349 million were up $43 million year-over-year, driven by capacity expansions for our specialties growth platforms to support plant-based proteins and sugar reduction. Finally, the board supported significant share repurchase programs in 2018 amounting to $657 million of expenditures.

Turning to our outlook. We anticipate 2019 adjusted earnings per share in the range of $6.80 to $7.50. This excludes the acquisition-related integration and restructuring costs as well as any potential impairment costs. We are expecting flat to slightly up adjusted operating income for the year, primarily due to our expectation that North America operating profit will be flat year-over-year.

Although we are benefiting from approximately $20 million of onetime cost impacts in 2018, we are expecting modest margin compression that can be explained by the following 2 circumstances coming together. First, the impact of U.S. and China trade negotiations on soybean supply and inventories in the U.S. is having a secondary impact on the cost of corn to us. We sell corn byproducts, which somewhat compete with soy meal protein and oil. These values have been down since the first half of 2018. In effect, this raises our cost of corn because we do not realize as much value from the sale of our corn byproducts. To remind you, co-product sales are approximately 14% of our net sales. Second, late in the contracting season, we experienced competition for sweetener syrup volume, and pricing gains were not enough to sufficiently offset the higher net cost of corn and inflation expected in 2019. We are pleased with the retention of our West Coast customer volumes as we transitioned service to other facilities in our network, and we expect our utilization rates to be significantly higher in 2019. Although these circumstances are impacting our 2019 North America profit growth expectations, we believe our operating model still offers the opportunity for long-run margin growth as we move more towards a greater weighting of specialty ingredients.

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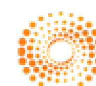

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We anticipate that the impact of foreign exchange will be negative for 2019, and we expect significant negative currency of $25 million to $35 million during the first half of the year relative to the prior year. We expect operating expenses, including corporate expenses, to be up year-over-year as we invest in global business process optimization and innovation to drive both cost savings and increased customer intimacy and growth. We expect financing cost for the year to be in the range of $82 million to $87 million due to higher interest rates on our floating rate debt and higher debt balance. Our adjusted effective annual tax rate is expected to be between 26% and 27.5%. We expect total diluted weighted average shares outstanding to be in the range of 68 million to 69 million for the year, considering the impact of the accelerated share repurchase agreement. Lastly, we anticipate cumulative Cost Smart run rate savings of $24 million to $34 million by the end of 2019 against wage inflation of 2.5% to 3%.

In North America, we expect net sales and volumes to be down. For the full year, we expect operating income to be flat to 2018, with the first half down due to the lapping of net corn costs, and the second half to be up as we lap more of the onetime impacts from 2018.

In regards to 2019 sweetener contracting, we were pleased with our volume retention, especially in light of our decision to stop production in Stockton. However, sweetener pricing gains were not enough to sufficiently offset the higher expected net cost of corn and inflation, which we anticipate will create slight margin pressure in our sweetener business. We are pleased with the results of our starch pricing and contracting negotiations.

South America net sales are expected to be up versus the prior year. Volumes are expected to be down, given Argentina economic headwinds and the impact on sweetener syrup sales. Given the anticipated rapid pace and magnitude of FX devaluations, we expect our business model required the first half to recover, so we anticipate operating income growth to be back-half loaded. In addition, we anticipate positive economic growth for Brazil. We remain watchful of economic reforms, inflation and impact on the upcoming election in Argentina. We continue to focus on business performance improvement and expect operating income improvement in the region.

Asia Pacific net sales are expected to be up and operating income is expected to be up modestly. We expect weaker operating income in the first half with a stronger second half. In EMEA, we expect net sales to be up. We anticipate strong specialties performance in Europe and core growth in Pakistan. Although we expect modest operating income growth, we anticipate currency and raw material cost overlaps in Pakistan will lead to a weaker first half versus the second half.

We expect cash from operations in 2019 to be in the range of $650 million to $700 million. We expect to invest between $330 million and $360 million in capital expenditures around the world to support growth as well as cost and process improvements. Importantly, we remain committed to returning capital to shareholders.

That brings my comments to a close. And now back to Jim.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Thanks, Jim. In closing, our leadership team remains focused on navigating a challenging macroeconomic environment impacting our core businesses in North America and Argentina. We are committed to driving operational improvements throughout our business and structurally lowering costs. Equally, we are energized by our commercial excellence initiative to grow, cocreate and win with customers. We are excited by the prospects of our recent specialties growth platform investments, which will provide new ingredients and formulating capabilities to deliver consumer-preferred innovation to our customers.

We are pleased to announce that we recently have been -- once again named Fortune's most admired companies list for the 10th consecutive year. We will be presenting at Consumer Analyst Group of New York on February 19, and I will discuss in greater detail our new specialty strategy, which includes 5 new specialty growth platforms which are sharply aligned with consumer trends.

And lastly, as we have recently demonstrated, we will continue to use our strong balance sheet to invest in specialties growth opportunities and pursue M&A. We remain committed to delivering long-term shareholder value.

And now, let's open the call for questions.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Robert Moskow from Credit Suisse.

Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

I was hoping you could help me understand the price negotiations for North America this year. You said that you expect profits to be down in sweeteners, but that you were pleased with the negotiations on starch. To what extent are you able to kind of still swing capacity from one to the other? And I guess that -- in the past, I've heard you talk about that as a lever you could pull if you're having trouble getting pricing or if there's too much volume in the market in one or the other. And then I had a follow-up.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Yes. I mean, I would just repeat that for sweeteners contracting, it basically -- we accomplished everything we wanted to accomplish in relationship to the Stockton closure and maintaining our West Coast customers. So there was no loss of share that we did not plan for. As it relates to how contracting went and pricing went towards the back end of contracting, there seemed to be more competitive intensity for volume, and therefore, pricing and margin compression occurred. And that's why we're indicating there's a little bit of margin compression in relationship to sweeteners. We were pleased, however, with the starch pricing and the contracting negotiations. The sweetener network for us this upcoming year is going to be operating at full capacity. And our starch production and inventory rebalancings are going on throughout the year and will steadily improve throughout the year. So that's basically how I would explain it, Rob.

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes. Rob, I might add that, while a lot of our infrastructure investment is around the corn receiving and the steeping and the wet mill, we always are thinking about finishing lines and CapEx that can allow us to toggle between what we do with the slurry that comes off of the starch grind. That transition takes more planning, and I would say the horizon on that is kind of multiple-year. So that's been a journey that we've been on as we think about which plants and then which finishing lines we would like to toggle more towards our starch and/or our specialty production. I think a good example of that is, as we added some capacity for the rare sugar allulose in one of our Mexico facilities, in order to make allulose, we're actually toggling on high fructose. So we use high fructose, we refine that down and down into a process where what you derive out is the rare sugar allulose.

Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. And I guess my follow up here is, you talked a lot about improving the mix through specialty starches and more capital being headed in that direction. Can you give us a sense of whether your profits in specialty starches were up or down this year? I know the percentage of your sales is up, but I guess I'm unclear on whether just moving in the specialty direction has -- whether the margin structure in that part of the business has held up and what your outlook is for 2019.

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes, sure. Rob, I'll take that question. Overall, just to start, our specialties are about 29% of our net sales. They sell at higher average price points per ton than the remainder of the business. And whether it's -- the gross profit margin levels are much higher than the remainder of our business. From year-to-year, as we target mid-single to high-single digit net sales growth in our specialty portfolio, we are seeing that corresponding type of gross profit growth. I think in '18, in particular, really within U.S./Canada, the co-product value pressures that we saw do impact specialties as

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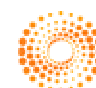

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well as our core sweetener and industrial starch business. But nonetheless, I still think, year-over-year, we saw growth in our overall profit pool of specialties. Particularly, in some markets where we're really seeing some strong specialty growth outside of U.S./Canada is where we really, really see some acceleration of that portfolio.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Yes. And I would just add that the price points have held. And in fact, obviously, we've been able to get the pricing up in tapioca related to the increases in raw material costs.

Operator

Your next question comes from the line of David Driscoll from Citi.

David Christopher Driscoll - *Citigroup Inc, Research Division - MD and Senior Research Analyst*

I wanted to come back to some of the points that Rob was raising and try it maybe slightly different. So it looks to me like your North American operations in 2018, profits were down more than $100 million. However, your volumes for the full year were not, they were flat. You closed Stockton. So just frame it for me, guys, why does it feel, when you say that you're not getting the pricing that you expected, like, why aren't you? It doesn't look like utilization rates would be down. I think you said you're running at full capacity. That normally would have correlated with a stronger ability or a better ability to get pricing. That's not happening, so there's some kind of disconnect, and I was hoping you could maybe explain why. And if somewhere in that answer, you could kind of tell me where you think industry utilization rates are, that would also be helpful. And then a follow-up, if I can.

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

I'm going to let Jim take a shot at that and then I'll add some commentary. I think, David, when we summarize North America and roll it up, we do kind of break apart into 2 big businesses underlying Mexico. So Mexico was seeing some volume growth. I also think that within U.S./Canada, we were seeing growth in our -- necessarily in our food starches. Where we faced the headwind was really in our sweetener volume portfolio, primarily U.S./Canada, and that was from 2017 into 2018, as we alluded to on calls, we really did see some unique challenges in high fructose into beverages. And that business was down 2x what we've seen our historical rate to be.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Yes. The industry data, David, I'm sure you're aware of this, is showing that for 2018, the rate of decline of HFCS has been now 2x the rate for, say, the previously 5 to 10 years. So there is absolutely a step-down or an increase in the rate of decline of HFCS, and we felt the effects of that in 2018.

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes. So then as we move to ceasing operations of Stockton in November, we're seeing some purposeful shed of sweetener volume, high fructose volume, there the last couple months of the year. As we move into '19, we expect that sweetener volumes to be down, '19 versus '18. What really occurred, I think, at the end of the year, David, was that we're moving the remainder of that West Coast volume back into our existing plants in U.S./Canada. We're taking that utilization rate up significantly as we head into '19. So that should help us with fixed cost absorption versus our overall sweetener in kind of our core plants. Did that answer some of your question, hopefully?

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David Christopher Driscoll - *Citigroup Inc, Research Division - MD and Senior Research Analyst*

It does. Just 2 quick follow ups. One, I think that you tried so hard in 2018 to recover some of this freight pricing, and I want to say that, that looks only to be marginally successful, but will like to hear your opinion on your ability in '18 to go back to customers and recover some of that freight inflation. And then my final question would just be we hear reports that there are significant unrest within the Mexican sugar industry and calls for some kind of punitive action taken against U.S. high fructose corn syrup. Could you just kind of bring this up to speed? And is there any risk on -- to the high fructose operations, either in Mexico or the U.S.-Mexican trade on high fructose, given some of the disruption that's been going on in the Mexican sugar industry?

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

I'll take the last question and then I'll come back to the freight. I am not aware of any acute near-term issues that are going to be problematic in relationship to the HFCS with Mexico. So we will look into that and we will certainly get back to you. But I am not aware of anything that's imminent in that regard.

As it relates to freight, the freight inflation that we faced in the first quarter of last year, we made significant progress against tightening up terms with customers and being able to pass through freight increases. And then we've obviously seen some moderation of those freight increases throughout the rest of the year. So we feel actually very good that we've been able to mitigate a large portion, the majority portion, of the freight increase that we absorbed in '18 and will benefit to some degree going into 2019, especially as it relates to dry van, which you remember, was the freight increase that impacted our starch shipments in the first quarter of 2018. And so that will be mitigated and improved situation as we go into 2019.

Operator

Your next question comes from the line of Ken Zaslow from Bank of Montréal.

Kenneth Bryan Zaslow - *BMO Capital Markets Equity Research - MD of Food & Agribusiness Research and Food & Beverage Analyst*

Just one high-level question. You continued talking about the commodity exposure and stuff like that. But the question that I have is, at what level of Ingredion's business, when you get to the mix, will the impact of commodity not be a source of ups and downs of profitability that -- or will be mitigated? How do you think about that?

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Well, I think as we've talked to in terms of our specialty strategy, with specialties representing about 29% of our net sales today, as we look forward over the 3 to 5 years and continue to make investments to add to our portfolio, I think when we get to the mid-30s as a percent of net sales for specialties, that the profit contribution from that is a bigger part of our profit pool. And because of the differentiation of our products, and as long as it's coupled with continuing to have great kind of customer service, I think we'll be insulated a bit more from some of the ups and downs that occur in our core business. How we sell our specialties and how our customers order is kind of a different process than necessarily the day-to-day, week-to-week ordering of what you see in a sweetener syrup business.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Yes. I just would add to that, that what we've experienced in 2018 and what we anticipate in 2019 is obviously, clearly, a more challenged operating environment. And there have been some significant impacts that we've talked about in relationship to commodity margin pressures, related to ethanol crush margins being at very, very low levels; and the net corn costs that have increased related to co-product revenues, just related to this China-U. S. trade dispute. Very unique situations that we have just not seen before that have impacted us to the order of magnitude in our core

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business. So all that being said, we've systematically stayed very, very focused and strategic in relationship to our specialties investments and growth. And we're very excited by the prospects of those. And again, we'll be talking more about that at CAGNY from a standpoint of the growth rate associated with all of those platforms and the impact that those will be having over time that will then mitigate any kind of earnings volatility. But what I would say is, in 2018, what we saw was extraordinary in relationship to the order of magnitude of our -- the impact to our core business related to some of those factors that I was talking about related to commodity margin pressures. So I anticipate, going forward, we'll see less of impact in that regard because of the contribution coming from the specialties investments that we are making.

Kenneth Bryan Zaslow - *BMO Capital Markets Equity Research - MD of Food & Agribusiness Research and Food & Beverage Analyst*

So my follow-up question is one, you did say that your gross profit is significantly higher, but you didn't talk about operating profit, which, quite honestly, is probably more important. And then the second question, part of that is, when you think about the earnings from the back half -- from the front half to the back half of the year, is that a normalization of this environment? Or is this just -- and is that kind of like where you're going to be in terms of the growth into 2020 as well? Or is this just saying, "Hey, it's just easy comps and that's just how the squishy year goes." So those are my 2 finals.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Do you want to take that back versus the front half on the phasing?

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Ken, I do think that as you think about '19, really, some of what we saw in the first half was -- first half of '18 was favorable -- or favorable net cost of corn. In particular, protein meal was pretty high and favorable. As we went into the second half of '18 and you started to see the headwinds against soy. And candidly, the soy crush margins were so attractive that you just had a lot of oil -- soy oil and soy meal coming off, and that started to depress corn meal, protein and corn oil prices. And we really felt that in the second half of '18, so we're going to have that continuing as a lap into the first half of '19. So I think we just have to get that through and then we'll see -- and that broadly impacts kind of all of the business within U.S./Canada. And then you'll see more of the normal drivers, I think, that we have behind the business and that are more in our control as we move into the second half of '19.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Right. And ForEx also, we're going to see significant ForEx headwinds continuing in the first half versus the second half. So there are those are 2 issues. And just to a modest degree, in Asia Pacific even, we're going to be lapping lower corn prices in the first half in Korea, for example. So there is this first half versus second half phasing issue that we anticipate related to the net corn cost squeeze or the co-product squeeze that we have highlighted, which we feel is a unique circumstance that manifested itself in 2018; ForEx, which will remain a headwind in the first half; and then even in some of the other regions, there's some unique impacts there that are phasing-related, first half, second half.

Kenneth Bryan Zaslow - *BMO Capital Markets Equity Research - MD of Food & Agribusiness Research and Food & Beverage Analyst*

So it's more of a comp issue, not a return to growth algorithm?

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

That's correct. Yes.

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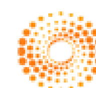

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James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

I think it's comp issue.

Kenneth Bryan Zaslow - *BMO Capital Markets Equity Research - MD of Food & Agribusiness Research and Food & Beverage Analyst*

Okay. For the specialty products?

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes. So Ken, I think I was trying to understand exactly your difference between gross profit and op income question.

Kenneth Bryan Zaslow - *BMO Capital Markets Equity Research - MD of Food & Agribusiness Research and Food & Beverage Analyst*

You just said that the gross -- I think your comment was -- I don't have it written down, I write sloppy, unfortunately. The gross profits was -- is higher -- your gross profit for specialty is higher than that -- and I think you gave a number of some sort, is higher than that of your base business, but you didn't translate that down to operating profit level, which I think is more telling, if that's okay.

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes, I would think that our -- generally, we have not really commented on the differences in op income between specialty or the remainder of the portfolio. That said, that when we think about our operating expense, which is both -- which obviously includes sales as well as kind of R&D support, generally, that was pretty in line with what we thought our overall kind of inflation would be. So that would have -- there wasn't anything that was unusual that would imply that there was kind of greater SG&A investment, I think, against our specialty business versus the other lines of business in the portfolio.

Operator

Next question comes from the line of Akshay Jagdale from Jefferies.

Akshay S. Jagdale - *Jefferies LLC, Research Division - Equity Analyst*

So just wanted to follow up, just clarification on the gross profit commentary on specialty. So you said gross profit for specialty was actually up. But just as a point of clarification, that excludes the impact of co-product credits, correct? Like...

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

No.

Akshay S. Jagdale - *Jefferies LLC, Research Division - Equity Analyst*

No. So your reported gross profit for specialty was up in 2018 despite the co-product headwinds, the production cost issues and whatever else, correct? So overall, gross profit in specialty was up?

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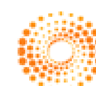

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James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes. I think Akshay, we're mixing kind of scope here. Specifically, when we're asked, the overall specialty business, we characterize as higher net sales growth, higher price points and higher gross profit margins. Generally, that business overall, globally, was still healthy, okay? Specifically, when we talk about comments upon co-product values and the headwinds there, that's kind of a U.S./Canada specific issue. And so I just want to make sure that we're -- when we're separating out the issues, I would say that we still -- overall, we're pleased with the way our specialty business performed in North America. I mean, there were the -- I think, the challenges of co-product values against all of the business in U.S./Canada, but we were still pleased with how we -- how specialties performed...

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

I think that's where the confusion occurred, is the comment was that we did also experience some impact related to the co-product revenue squeeze that would the impact the specialties business as well. But overall, we're very pleased with the performance of the specialties business and the specialties profitability.

Akshay S. Jagdale - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And just going to the whole co-product issue. I think last quarter, you gave us a nice earnings bridge of $100 million drag. Was the co-product issue, was that included in the $40 million from freight, manufacturing inefficiencies and commodity margins? Or this a different bucket now? And can you just help us quantify that impact and maybe give us a sense of, like, can that move around if co-product credits increase from here?

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes, I think when we addressed on the Q3 call, when we laid out the various drivers, we did call out, I think, a bucket which was freight and EMEA inflation and commodity pricing pressures, which had increased from our $40 million estimate we previously communicated. I'd say that's about $45 million, and that's really just the step-up in the co-product value decrease that we were experiencing here. But generally, given what we had talked to in Q3, the drivers were very, very -- kind of played out as we were trying to outline at that time.

Akshay S. Jagdale - *Jefferies LLC, Research Division - Equity Analyst*

Got it. And so just related to that, so can you help us understand what the -- if you were to do a bridge for next -- for '19, you mentioned 2 major headwinds. One was the co-product credit hitting you guys, and then the other was in your sweetener business margins being compressed. Can you give us some ballpark on those 2? And I mean, on the co-product side, it's kind of out of your hands, it's supply/demand, right? But that can -- am I right in understanding that if spot prices move up there, that will flow through your P&L?

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Yes, on that last point, yes. And that's one of the reasons why we have set guidance where we did with such a wide range, if you want to call it that, because of that exact fact. But I'm going to let Jim answer the question that you asked.

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

And Akshay, I think maybe to help everybody on the call, against our North America business, what we really see is Mexico, modestly up. I think if you look at the U.S./Canada business, we would expect our food starch business to be up. It's going to benefit a bit from what we would see in specialty top line growth as well as we continue to work through our starch rebalancing and our production issues. Those will play out kind of all throughout '19 as we've talked to you before. And we hope to be in a better position as we start into 2020. Against the sweetener and industrial business, we would have expected a step-up as we lap the onetime impact that the Argo shut down as well as some of the operational efficiencies.

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And what we've really seen is that, combined with a relatively tight pricing market, but the impact as well of lower co-product values on our overall gross cost of our corn, we're actually seeing that business modestly down for the year. So those 2 kind of come together. They necessarily offset, and that's why we're seeing kind of a flat operating income expectation for North America. I would say as well is that we are really just carrying forward an expectation that ethanol crush margins remain low. Again, it's not a big part of our business. It was something that was unexpected in 2018 as an impact. But right now as we look forward to 2019, within our guidance, we see that as relatively kind of staying the same. To your point, are there upsides if either ethanol crush margins move up or if we see some of the co-product values start to increase, I think that, that would benefit our overall business within North America. But that's not currently necessarily in our guidance.

Akshay S. Jagdale - *Jefferies LLC, Research Division - Equity Analyst*

Got it. And just one last one, more on the specialty business long term, right? So obviously, there's been a lot of noise operationally and in the core business and margins have come down for the company. But in the background, it seems like you're investing pretty heavily on specialty. So can you just give us a perspective on that? And like, what does that mean? I mean, should we expect you to increase at some point your long-term guidance on growth for that business? Is that something we should expect down the road as a function of all the investments you're making?

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Yes, well, I mean -- thank you for highlighting the investments that we've made in specialty capacity increases, specifically in China, Korea, the U.S. and Mexico. And again, we're very excited. We went through a strategic review in 2018 of our specialty strategy to refine it, and that's led to 5 growth platforms that have us very clearly focused on the future investments that we will be making. We'll be sharing this at CAGNY. And again, those, we anticipate, will have above-market growth rates associated with them with headroom for growth in each one of those. And again, we'll be weaving all of that into our -- both say, near or midterm outlook for profitability as well as a longer-term outlook for profitability. And that's what we intend to talk about at CAGNY. And it'll be greatly emphasized around specialties, and then obviously balanced by taking into account what we're experiencing these last 2 years, last year and this year, and kind of taking a read on that environment that's impacting our core business. If that helps, Akshay.

Operator

Your next question comes from the line of Heather Jones from the Vertical Group.

Heather Lynn Jones - *The Vertical Trading Group, LLC, Research Division - Research Analyst*

I have just a details question first. Reading the language in the press release, I just wanted to clarify. So it sounds like the ASR, you all expect that to be complete pretty soon?

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

That's correct. Yes.

Heather Lynn Jones - *The Vertical Trading Group, LLC, Research Division - Research Analyst*

Okay. Then moving on to your operations. I guess first, was wondering if you could share with us your view of what's driven the acceleration? You mentioned that the decline in sweetener volumes for the U.S. industry, in general, is 2x the previous 5 or 6 years. Wonder if you could share your view of what's driving that acceleration.

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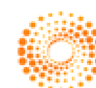

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James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Well, I think it's what we're all seeing in relationship to the concerns with sugar intake in general. I think it's not just against HFCS, I think also sugar itself is being formulated out of many products. But it's consumer preferences, really, that I think are driving a lot of that demand. The move towards smaller can sizes, I guess, for full calorie products from a standpoint of caloric intake; and just a lot of the consumer trends that are driving government behavior, et cetera. If you look in -- certainly, in Argentina, what we've experienced was just related purely, we believe, to macroeconomic demand disruption related to high inflation and consumers just getting squeezed. In North America, it's more trend-related, consumer trend-related.

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

I would say, also just to add, I think tactically for 2018, there were some impacts on cost to the beverage manufacturers. We suspected that we would see some higher prices at retail. And I think if you kind of look at the scans data for the second half of the year, whether it's IRI or Nielsen, generally, full-calorie soda unit prices were up. And I think that, that led to a bit of a volume headwind in terms of consumption. Then obviously, that leads to a bit of volume challenge for us and our shipments of HF 55 into our beverage customers.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

That was something actually that, I think, Jim had signaled in quarter 2 that was likely to happen related to aluminum prices going up and related to PET prices going up and the beverage manufacturers putting through price increases. And there certainly was a contributing factor to that.

Heather Lynn Jones - *The Vertical Trading Group, LLC, Research Division - Research Analyst*

And that makes sense. So following that logic, is it fair to assume then that you all saw an acceleration, not just from prior years, but an acceleration decline as 2018 progressed into 2019?

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes. I think what you saw was that during more of the summer months in '18 was when that change manifest itself. And so that plays out in Q4. For us, there will be a little bit of that lap as you go into the first half of '19, but then it'll be back into kind of whatever the normal year might be for how the beverage customers see the marketplace in 2019 [right now].

Heather Lynn Jones - *The Vertical Trading Group, LLC, Research Division - Research Analyst*

And you mentioned that for Stockton, the closure of that facility, that you kept up the volume you were intending to keep, but that your volumes in North America will be down. Do you have an estimate of what sweetener sales will be on a pro forma basis for that closure for -- as a percentage of North American sales?

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes. I think we do -- I mean, generally, when we looked at that facility, we don't -- I won't give you the specifics. But we looked at that facility, I think we were intending to shed probably less than about 20% of the volume at that facility, and we were anticipating keeping about 80% that we could see, that we could reasonably serve and source from other plants within our network.

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Heather Lynn Jones - *The Vertical Trading Group, LLC, Research Division - Research Analyst*

Okay. And then my final question is on your projection for '19. Was wondering if you could share with us what your assumption is as far as the whole Brexit issue. I know it's not a huge proportion of your sales, but it seems like it could have an impact on Europe and all. And just wondered if you -- what your assumptions are there.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

I think I'll take a shot and then I'll let Jim finish it up. I think -- obviously, if there's a hard Brexit or a Brexit with no resolution, which would be worst-case scenario, it's more the impacts to the overall EU and the U.K. which could be problematic. If there is a soft Brexit which is what's on the table now or some sort of resolution, we don't really think the results of that are going to be material to our business really. Jim?

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes. The 2 tactical things that we want to plan for is that, if there is anything on a hard Brexit, and all of a sudden, there's new customs, borders that are formed, we want to make sure that we have inventory in the right place so that any of our food customers don't face any immediate outages. And then second, we have to deal with whatever the imposed tariff levels would be. And at some point, whether or not immediate or over a course of 1 year to 1.5 years, those tariffs are going to play a role in increased cost of manufacture. And eventually, those will play through to a consumer at a shopping or a restaurant. And that should actually create a bit of a headwind in terms of some of volume decrease. So really, you got to -- those 2 things, we really kind of anticipate, would be how that might move forward. But it all depends upon the suddenness or the gradualness of how Brexit plays out.

Heather Lynn Jones - *The Vertical Trading Group, LLC, Research Division - Research Analyst*

And my final question, hopefully, is a quick one. But I know you guys don't really do brewing in the U.S. But my question does have implications of broader industry, and thus, you guys. This push to get away from corn derivatives and brewing and move towards more "authentic" 100% barley, is that just headlines at present? Or are you seeing in the broader industry a trend towards that, that could affect the supply/demand balance in the U.S. over '19, '20?

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Well, we weren't seeing that in the U.S. And I think we know why you're asking that question.

Heather Lynn Jones - *The Vertical Trading Group, LLC, Research Division - Research Analyst*

Yes, yes.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

But in relationship to our business, majority of our sales into brewing is in Mexico as well as in South America and less so in the United States. But Jim, do you want to make some additional comments?

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Well, I just think that the choice of the adjunct that the brewer uses is also very much a cost and a yield and a capacity throughput issue, right? So there's trade-offs that our customers make. But to Jim's point, mostly, our business is primarily Mexico as well as in South America.

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Heather Lynn Jones - *The Vertical Trading Group, LLC, Research Division - Research Analyst*

But for the U.S. industry, which you could -- which would impact overall supply/demand, you're not seeing a big shift in the overall industry so far in the U.S.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

No, no, no. No, I don't think so. I think the industry is battling itself for share, and they're looking for opportunities to create points of differentiation.

Operator

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

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

A lot of ground's been covered, so hopefully, I keep this brief. Just first, on the cash flow. You made some comments in the prepared remarks about changing customer financing in Mexico, but it came in notably below kind of where you guys were 3 months ago. And it was both on the onetime tax refund as well as the continuing ops. And just a little bit more color on how those 2 dynamics played out and what actually happened there.

James D. Gray - *Ingredion Incorporated - Executive VP & CFO*

Yes, I think with regard to the, really, the working capital, Adam, I think that was probably more of the major change that we were expecting. As we saw as the year played out, both in North America, to a lesser extent, in South America, we have various programs where you can discount an invoice and sell it to an intermediary. As you saw short-term rates starting to climb significantly as you look at maybe a 3-month or 6-month LIBOR, it just became evident that in the second half of the year, it made more sense to reduce or halt the sale of any of those discounted invoices and just hold on to it and then collect the revenues directly from the customer. So that has an impact on your accounts receivable balance as it grows. It also allows us to be a bit more in control of our accounts receivable. And then we can use other means of short-term financing where we think we can get kind of a better overall cost and balance. So you'll see the impact in your net working capital, but we might find that there's other short-term debt opportunities that are actually quite -- or more affordable for the company to go access.

And then just your comment on the tax flows. Those do play back and forth in terms of as we're looking at both the settlement in terms of our U.S.; and Canada, kind of reviews and appeals that we've had in place and those have played out. And then also as we look forward to really getting clarity on the impact of GILTI and FDDI -- or FDII on overall credits for taxes. So we can talk more off-line on that, but...

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

Okay. Two other quick ones on North America. Just contracting, kind of the comments were that it weakened later in the contracting season. Is that -- do you think that was more a function of the sweetener demand side? Or that was that the weakness accelerating, and that becoming more evident to your competitors? Or do you think it was a factor of ethanol margins being pretty lousy, and some of the competitors having ethanol capacity -- ethanol wet mill capacity that they can switch over to HFCS? Both? Or other factors?

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Yes. I mean, we don't really know what drove competitive actions. I think both of what you just described are plausible explanations for what drove that behavior.

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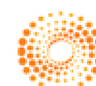

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Adam L. Samuelson - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. And then last one, just going back to, I think it was Heather's question about the use of corn derivatives in the beer industry. You talked about Mexico a lot, but Brazil, I mean, is it -- are you seeing that pressure in Brazil? I know that's an important market for you. And some of your bigger customers, I think, are facing some pressure there as you're seeing kind of the value segment of that market in malt-only beers grow. Is that something that's more evident in your volume data that -- or and -- just talk about that.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

I would say that if there was a trend that starts to manifest itself in the United States, should something manifest itself in the United States, we're obviously going to be very watchful of where that may carry over. But as of right now, there's nothing material that's impacting our business related to that or some of this new noise or marketing positioning that's taking place that we saw on Sunday last week.

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

Yes. I wasn't talking about the Super Bowl specifically, I was just more in Brazil. I mean, the value segment of the market and malt-only is growing a lot faster than the mainstream. And my understanding was that it was the mainstream that uses maltose.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

What I would say is that we are very in tune to all the trends that are developing in Brazil because we do supply to the brewing industry in Brazil. And anything that we would be -- anything that would be happening, we would also be working with those customers from an innovation standpoint as well. So -- but nothing that's, right now, any kind of a problem for us that we want to surface. But we're working with those customers to evaluate trends as they develop and also work with them from a standpoint of innovation on adjuncts that they may need for the future.

Operator

And at this time, there are no further questions.

James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

All right. And then I would just like to conclude by thanking everyone for their time today. And hope to see many of you in February at the CAGNY conference.

Operator

Ladies and gentlemen, that does conclude your conference for today. Thank you for your participation and for using AT&T Executive Teleconference, you may now disconnect.

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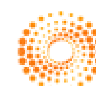

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