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EDITED TRANSCRIPT

INGR - Q3 2018 Ingredion Inc Earnings Call

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OVERVIEW:

INGR reported 3Q18 YoverY sales decline of 2%, reported operating income of $155m and reported EPS of $1.32. Co. expects 2018 adjusted EPS to be $6.80-7.05.

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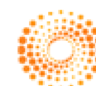

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Ingredion Third Quarter 2018 Earnings Call. (Operator Instructions) As a reminder, this conference is being recorded. It's now my pleasure to turn the conference over to your host, Vice President of Investor Relations and Corporate Communications, 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 Third 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 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 8-K. During this call, we also refer to certain non-GAAP financial measures, including adjusted earnings per share, adjusted operating income and adjusted effective tax rate, 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.

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

Thanks, Heather, and welcome to everyone joining us today.

The Ingredion team is working effectively to navigate both the challenges of the macro environment and capitalize one of the opportunities presented by the shifts in consumer preferences and changing customer landscape. We are becoming a more agile company. We are aligning our resources and cost base to drive long-term profitability, and are making progress in better positioning the company for future growth.

With that said, we are disappointed with the third quarter's results. Specifically, in the latter half of the quarter, our results were impacted by unexpected events. We experienced the effects of rapidly changing foreign currencies, primarily in Argentina, Brazil and Pakistan, and we responded

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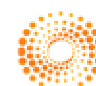

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to unplanned power outages at our largest manufacturing facility in North America. We are addressing these challenges by aggressively driving operational improvements, structurally reducing costs and taking necessary pricing actions, while ensuring we deliver on our customer experience commitments. To accelerate operational execution, we have restructured the North America supply chain leadership, bringing intense focus to freight cost optimization and reducing complexity. We continue to make progress on rebalancing starch production and inventories across our network. Further, to better align our manufacturing cost structure to future sweetener demand, we have progressed the transition of Stockton customer volume and service to other plants in our network. We anticipate the sensation of production in Stockton by the end of November.

Now, moving to the third quarter results. Ingredion volumes were flat. Specialty sales growth was offset by core volume decline. North America and South America operating incomes were down. Asia Pacific continued to be impacted in the quarter by extraordinary tapioca costs, although less than in the first half of the year due to recent pricing actions.

EMEA continued to perform well in spite of ForEx headwinds, with operating income flat in comparison to last year.

Consistent with our strategic intent to grow our specialty's portfolio, we continue to see strength in our on-trend growth platforms, such as clean and simple ingredients and specialty texturizers.

During the quarter, we announced $60 million of planned specialty investments in Asia Pacific. These investments will further expand our capacity in modified waxy corn food starches in China, and tapioca and rice specialty starches in Thailand to meet growing global demand.

We remain focused on delivering shareholder value. We continued to deploy cash, with nearly $177 million of share repurchases during the first 9 months of 2018, including $36 million in the third quarter. The board approved the dividend increase for the fourth consecutive year, and also approved an additional $8 million share repurchase authorization. This morning, we announced our attention to enter into a $4 million accelerated share repurchase agreement.

Before moving to our regional overview, I would like to update you on the progress of our Cost Smart program. As mentioned in the last quarter, in response to the inflationary increases that are impacting our industry, we formalized our $125 million Cost Smart savings program. We have taken a number of actions that will be completed by year-end, including the sensation of production at Stockton, which we expect will save $6 million to $9 million.

In addition, we further consolidated finance activities by announcing the opening of our Latin America shared service center in Guadalajara, Mexico, building on the successful model we established in Tulsa, Oklahoma last year.

Finally, as mentioned, we restructured our supply chain leadership, which is enabling improved operational effectiveness and increased productivity.

Anticipated cumulative cost run-rate savings of $4 million to $5 million are expected in 2018, and by 2019, we expect $24 million to $34 million, building to $125 million by year-end 2021.

Collectively, our Cost Smart initiatives continue to move us toward becoming a more streamlined and agile organization.

Now, moving to North America. Third quarter operating income in North America was $138 million, down 22% from last year. Overall volumes were flat as higher Mexico and specialty volumes were partially offset by lower U.S., Canada volumes. Our production costs were higher due to the earlier mentioned unplanned outages, our rebalancing of starch production and inventories across our network as well as operational inflation. We also continued to experience the residual impact of increased freight costs on our business. Lastly, we continue to experience weaker-than-expected sweetener volumes.

In South America, third quarter operating income was $22 million, down $4 million from the year ago period.

During the quarter, we experienced significant FX headwinds, caused by the weakening Brazil real and the Argentine peso.

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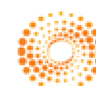

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Volumes were down 4% for the quarter due to weakness in brewery sales.

We continue to monitor the macroeconomic environment in Argentina and Brazil, and take pricing actions as needed to recover devaluation impacts.

Moving to Asia Pacific. The region delivered $25 million of operating income, down 17% versus the prior year. Although volume was down 1% due to seasonal issues in Korea, specialty sales were up in the region. The region delivered strong price mix, which led to 4% net sales growth. The pricing actions we took in each quarter this year to offset the rapid rise in tapioca costs led to continued margin recovery in the quarter, and we anticipate a return to a historical average tapioca harvest.

Finally, the EMEA region continued to perform well in spite of foreign exchange headwinds, delivering third quarter operating income of $26 million flat to last year. Higher specialty and core volumes were offset by unfavorable foreign exchange and higher raw material costs in Pakistan.

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

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

Thank you, Jim. I'll start by covering the highlights of the income statement.

Net sales were down for the quarter. Unfavorable foreign exchange more than offset favorable price mix.

Gross profit margin was lower by 300 basis points, driven by weaker performance in North America and Asia Pacific and foreign exchange headwinds in South America.

Reported and adjusted operating incomes were $155 million and $189 million, respectively.

Reported operating income was lower than adjusted operating income by $34 million. The difference was due to $31 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 $1.32 and $1.70, respectively.

Moving to the net sales bridge. Our sales were down 2% versus last year. Unfavorable FX of $76 million was primarily attributable to currency devaluations in Argentina, Brazil and Pakistan.

Volume declines were $6 million. This was partially offset by $47 million of favorable price mix.

By region, you can see unfavorable foreign exchange affected all 4 regions, but was most pronounced in South America and EMEA.

In North America, volume was flat year-over-year. Specialty volumes were up, but this was offset by lower sweetener volumes.

Price mix in North America was down given higher freight costs.

In South America, volume was down 4% due to weaker brewery sales.

Price mix was up, driven by the pass-through of higher raw material costs and foreign exchange in Argentina and Brazil.

APAC volume was down due to seasonal issues in Korea. EMEA had strong volume growth driven by specialties in Europe and Pakistan core demand.

For the quarter, reported and adjusted operating income decreased $76 million and $50 million, respectively.

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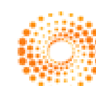

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North America operating income decreased $39 million due to higher production costs, driven primarily by several unexpected power outages at our largest sweetener facility, continued starch inventory rebalancing, lower sweetener volumes and higher freight and manufacturing input inflation.

South America operating income was down $4 million, driven by significant foreign exchange headwinds.

Asia Pacific was down $5 million, driven primarily by higher tapioca costs and the layout of corn costs in Korea.

EMEA was flat with specialty and core volume growth, offsetting unfavorable foreign exchange and higher raw material costs in Pakistan.

Corporate costs were higher by $2 million for the quarter, given continued investments to drive innovation and to further optimize global pressures -- global processes via our Cost Smart savings program.

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 $0.49 per share, primarily driven by a margin decline of $0.39 per share attributable to North America.

Unfavorable foreign exchange was $0.14 per share.

The margin and FX declines were partially offset by increased volume of $0.03 per share and other income of a $0.01.

Moving to our non-operational items. We saw a decrease of $0.02 per share for the quarter, largely driven by higher financing costs, partially offset by taxes and shares outstanding.

It's worth to note financing costs were $0.10 decreased, driven largely by the impact of unfavorable foreign exchange on Argentina's balance sheet, including the effects of hyperinflation accounting as compared to a year ago period.

Adjusted taxes were $0.05 per share lower, primarily driven by U.S. tax reform. Shares outstanding contributed a benefit of $0.03 a share.

Let me move to year-to-date financials. Net sales were flat year-to-date. Gross profit was lower by $64 million as a result of declines in North America and Asia Pacific, which more than offset better performance in South America and EMEA.

Reported and adjusted operating incomes were $545 million and $590 million, respectively.

Reported operating income was lower than adjusted operating income by $45 million. The difference was due to $31 million of restructuring charges associated with our Stockton, California facility, $9 million of charges associated with Cost Smart SG&A initiatives, and $5 million of other restructuring costs.

Our reported and adjusted earnings per share were $4.80 and $5.31, respectively.

Moving to the net sales bridge. Our year-to-date sales were flat versus last year.

Unfavorable FX of $97 million, primarily attributable to Argentina, Brazil and Pakistan, was offset by volume growth of $53 million and price mix of $64 million.

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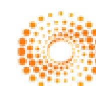

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As we look more closely by region, you can see unfavorable foreign exchange affected South America, predominantly driven by the Argentine peso and Brazilian real.

Volumes were up in South America and EMEA. In North America, volume was flat, with increases in Mexico and specialty ingredients offset by lower sweetener volumes.

In total, price mix was up 1%. Price mix was flat in North America due to higher freight costs. In our other regions, price mix was up due to pass-through of raw material costs and FX.

Year-to-date reported and adjusted operating income decreased $89 million and $79 million, respectively.

North America operating income decreased $84 million due to higher production costs, driven by unplanned power outages at Argo, continued starch inventories rebalancing, lower sweetener volumes, higher freight and manufacturing input inflation and some commodity margin pressure.

South America operating income was up $23 million, driven by volume growth and our more competitive cost structure in Brazil due to network optimization, and in Argentina due to our new labor agreement and organizational restructuring.

Asia Pacific was down $15 million driven by higher tapioca costs. EMEA was up $3 million with specialty and core volume growth more than offsetting the higher raw material costs in Pakistan.

Corporate costs were higher by $6 million given the same reasons impacting the quarter.

Moving to the earnings per share. Operationally, we saw a decrease of $0.77 per share, primarily driven by a margin decline of $0.89 per share and unfavorable foreign exchange of $0.13 per share.

North America and Asia Pacific declines more than offset margin improvement in South America. The margin decline and unfavorable foreign exchange was partially offset by increased volume of $0.23 a share and other income of $0.02 a share.

Moving to our nonoperational items. We saw an increase of $0.10 per share for the -- largely driven by the lower tax rates and shares outstanding.

Adjusted taxes were $0.15 per share benefit, driven primarily by U.S. tax reform while shares outstanding contributed a benefit of $0.05 a share. These benefits were partially offset by higher financing costs of $0.09 a share, which includes the impacts of Argentina hyperinflation accounting.

Moving on to cash flow. Year-to-date cash provided by operations was $579 million. Capital expenditures of $234 million were up $12 million year-over-year, driven by specialty capacity expansion.

Additionally, as Jim mentioned earlier, we've bought back 1.6 million shares for $177 million.

Turning to our guidance. As mentioned in our preannouncement release, we anticipate 2018 adjusted earnings per share in the range of $6.80 to $7.05. This reflects anticipated foreign exchange headwinds in Argentina, Brazil and Pakistan, and a lower operating income outlook for North America. This excludes acquisition-related integration and restructuring costs as well as any potential impairment costs. We expect net sales and volumes to be up from 2017, and we expect continued growth in specialty sales. We anticipate that the impact of foreign exchange will be $0.25 to $0.35. As we've explained in the past, given our business model, for most regions, foreign exchange is effectively a pass-through over time.

We expect operating expenses, including corporate expenses to be up year-over-year, as we invest in global business process optimization and efficiency to drive long-term structural cost reduction under our Cost Smart program.

We expect financing costs for the year to be in the range of $80 million to $85 million due to higher interest rates on our floating-rate debt, refinanced maturities and the impacts of foreign exchange revaluation for hyperinflation accounting.

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Our adjusted effective annual tax rate is expected to be between 26.5% and 28%.

This reflects a benefit of approximately 2 percentage points compared to our weighted average effective tax rate from 2017, driven primarily by U.S. tax reform.

We expect total diluted weighted average shares outstanding to be in the range of 71.8 million to 72.0 million for the year, taking into account the impact of the accelerated share repurchase agreement.

In North America, we expect net sales and volumes to be flat. For the full year, we expect operating income to be below 2017.

We expect higher production costs driven by unplanned electrical outages, continued starch inventory rebalancing, lower sweetener volumes and higher freight and manufacturing input for inflation.

South American net sales are expected to be up versus the prior year. Volume recovery and favorable price mix are expected to offset foreign exchange headwinds. And operating income is expected to be up. However, given the rapid pace and magnitude of FX devaluations in Argentina, we expect our business model will require more than a quarter to recover.

In addition, we anticipate positive economic growth in Brazil. We remain watchful of the economic reforms and inflation 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, but operating income is expected to be down given tapioca cost headwinds.

We anticipate strong specialties performance across EMEA will continue to support operating income growth in the region.

In Pakistan, currency and raw material cost headwinds are expected to be partially offset by higher volumes and price mix.

Excluding onetime cash benefits from tax receipts, we expect cash from operations in 2018 to be in the range of $720 million to $750 million.

We expect to invest between $330 million and $360 million in capital expenditures around the world in 2018 to support growth as well as cost and process improvements.

Importantly, we remain committed to returning capital to shareholders, as we demonstrated through the first 9 months with repurchase of 1.6 million shares, our fourth consecutive annual dividend increase, and the announcement of a $4 million accelerated share repurchase.

The initial settlement of the ASR transaction will occur earlier in November. That brings my comments to a close. And let me turn it back to Jim Zallie.

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

Okay, I would like to announce today that in keeping with our strong commitment to sustainability, we have posted a global reporting initiative, a GRI Index to the sustainability page of our website. This further aligns us with voluntary reporting requirements and the expectations of our stakeholders.

In closing, our leadership team remains focused, and we are as committed as ever to drive operational excellence and win with customers.

We are tackling our challenges, making the necessary changes to strengthen our business and navigating the impacts to our industry and business.

Our global organization is highly engaged in refining and evolving our path to profitable growth.

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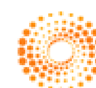

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This centers on continuing to deliver exceptional customer value by being easy to do business with and being a true innovation partner.

And as we have 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 shareholder value. And now, let's open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of BMO Capital Markets. Please state your name.

Ken Zaslow - *BMO Capital Markets - Analyst*

Just couple of questions that I have. One is, can you talk about how the outage actually occurred? And then what are the ramifications to kind of cleaning it up and what's the timeframe to which that will happen?

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

Sure, very much. So very unexpectedly, we experienced 3 successive power failures in our main substation at Argo over a 3-week period. The outages, basically they shut down our boilers, and a plant of Argo size takes 7 to 10 days to stabilize production per incident. We believe complete utility outages of this magnitude in 3 weeks are extraordinary, and something we've not experienced in the 3 decades -- in the last 3 decades at Argo. And so those issues are behind us. They hit us in the middle part of the quarter, and the impact financially impacted us in the latter part of the quarter.

Ken Zaslow - *BMO Capital Markets - Analyst*

And what's the timeframe, so it is completely past us? Is it...

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

It is past us, and the plant is operating at normal production rates right now and has been for the last few weeks.

Ken Zaslow - *BMO Capital Markets - Analyst*

So then when I think about 2019 and beyond, how much of the issues in North America will reoccur? And will you be able to recover and get to a more sustainable margin? How do you think of that given all the issues that have happened in North America? And then on top of that, just also think about the high-fructose corn syrup demand that has come out, how do I frame the North American business for 2019, 2020?

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

Sure. So let me start by trying to answer the question, what happened in North America this quarter and year-to-date and then try to address all of your questions. We've clearly had a challenging year and are making the necessary changes to address the situation in North America. So off our North America 2017 operating income base of $654 million last year, let's walk through the full year outlook bridge. Starting with the most recent events. The unplanned power outages at Argo, we estimate the full impact of that to be $10 million, the majority of which hit us in this

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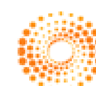

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quarter. Now let's move to something we talked about in quarter 1, which was freight and then talk also about ME inflation which we call manufacturing expense inflation, which has impacted us in the year, and also commodity pricing pressures combined. So that bucket. We estimate the full year impact of these to be $40 million. Next, sweetener volumes, and the associated impact on our fixed cost absorption in our network. We estimate that impact to be $20 million. Our starch rebalancing is estimated to be $20 million, and some operational inefficiencies are estimated to be $10 million. So in regards to which of those headwinds for the full year are transitory versus is structural? What I would say is at this point in the year, there are many unknowns related to the uncertainties in the macroeconomy, the trade situation, incremental inflation beyond what we've experienced in 2018 and 2019 -- 2018 and then going out to 2019, and then obviously, 2019 contracting, which is an unknown. So we expect the impact of the Argo outage and operational inefficiencies to be short-term transitory effects. Our team is working very hard against the $40 million headwinds related to freight, ME inflation and commodity margin pressures within the industry that are being felt within the industry. We believe the $20 million impact attributable to starch rebalancing should steadily improve throughout 2019. And the $20 million impact of sweetener volumes to be structural in nature, but in response, we've announced the cessation of wet milling at Stockton, which should yield $6 million to $9 million of savings. So we are obviously taking very aggressive actions and move with a sense of urgency in our North America business. As mentioned, we restructured our supply chain leadership, bringing intense focus to freight cost optimization and working to reduce complexity in our production facilities. So hopefully, that walk provides you a very clear explanation of what's happened in 2018, and our best view right now about what's transitory versus structural and the best view we have right now for 2019.

Operator

Our next question comes from the line of Credit Suisse Securities. Please state your name.

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

Kind of similar, what is the...

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

Bob -- Roby, that cut off at the beginning of your question. Can you repeat it? I am so sorry.

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

Sure. My question is, if you go into price negotiations with volumes declining and sweeteners, what's the industry logic for trying to get a price increase? Is it to offset commodity inflation? Because I would imagine corn is pretty flattish. And when are we going to know what the conclusion of that is? Will it be in January like we normally hear?

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

Yes, typically, we obviously don't comment at this time of year regarding contracting, but we will in quarter one. Certainly, we believe the entire industry is feeling inflationary impacts right now. And I'm going to let make Jim make a comment related to corn because I think it is something that we did want to kind of highlight in relationship to what we call commodity price -- commodity margin pressures, Jim?

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

So, Rob, one of the things that were -- we've heard couple of comments that corn might be flattish for the year. But also recognize that part of our corn costs is offset by our co-product -- the sale of co-products. And what we're seeing is that with the soybeans backing up in the U.S, those have really pressured some co-product pricing, which net increases our overall cost of corn. And I'd say that, that -- it's a pretty unique dislocation related

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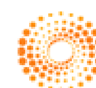

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to the current trade disputes between U.S. and China. The carryout expected on soybeans is pretty high for the end of this year. So we don't see that unwinding soon. I do think that the layout of our cost of corn or the net cost of our corn will be higher in the first half of 2019.

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

So two follow-ups on that. Does that mean that you think all of your competitors will face similar net corn costs situation and therefore use that as part of the logic? And then secondly, I guess on the starch rebalancing, can you give a little bit more detail on what you're rebalancing? I mean does that include just the structural shift away from sweeteners in your starch stream and into more value-added starch products? And if so -- I think you said that was -- is that a structural cost or is it something that -- I can't remember if you said it was structural or not? Because it would seem structural if it means just demand is shifting away from one -- from the sweetener side?

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

Rob, I'll finish it up on corn and then -- and hand the starch inventory rebalancing back to Jim. But with regard to corn, I can't say exactly what our competitors face. But what -- some of the publicly available quotes on things like cornmeal or corn oil, it's pretty easy to see the trend in those. And those are publicly quoted from multiple sources. Maybe, Jim you could address...

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

Yes, so just in relationship to the starch production imbalance that we referred to. We actually talked about this in earlier quarters because it started to impact us in quarter one, if you remember, primarily, on our industrial starch volumes, which typically are much larger in quantity because they're shipped in bulk. And due to -- it's a long time ago, but due to some very cold weather in the harshest part of the winter, we suffered some production imbalances at the same time as we were trying to optimize our North America production across 3 different plants. And so those are challenging moves when things are going normal. And then throw on top of it a weather-related issue that impacted industrial starch. And also there was some softer customer demand related to those same weather-related issues and supply chain issues that impacted the entire industry or -- with trucking availability et cetera. So throughout this year, we've been working to rebalance our starch production networks. And we see the situation improving and steadily improving throughout 2019. And that's why we said against that $20 million headwind, we see us mitigating to offsetting most of that as we go through 2019.

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

Okay, so it has nothing to do with shifting your stream of how you -- how the corn flows through the plant? Whether it goes into starch or sweeteners? It's really just within...

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

No, no, no, it's primarily within our starch network. It's primarily optimizing lines that would produce on either food or industrial. And to be quite frank, it's also related to trying to accommodate growth in other base starches that typically we wouldn't produce in North America because of growth in specialty tapioca, potato and rice. That typically would be produced outside of North America, but to accommodate customer needs, we've tried to put those in. And when you do that, you create challenges for a plant that is dedicated to corn.

Operator

And our next question comes from the line of Jefferies LLC. Please state your name.

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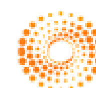

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Akshay S. Jagdale - *Jefferies LLC, Research Division - Equity Analyst*

It's Akshay Jagdale at Jefferies. Can you hear me?

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

Yes, we can, Akshay.

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

Perfect. Thank you for that bridge. That's super helpful. I just want to make sure I caught all the buckets. So if I can repeat them, power outages $10 million, Freight, manufacturing and inefficiencies and commodity costs of $40 million. Sweetener demands $20 million. Rebalancing is $20 million, and there was another $10 million, which was also operational inefficiencies. Is that right?

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

Yes, it's kind of a catch you all bucket, but yes, that's right, yes.

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

Akshay, sorry, what we were describing in this freight inflation, some of the manufacturing inputs we've had inflation in chemicals and packaging. And then we've got some commodity margin pressures. That bucket we've kind of combined as $40 million because it's largely inflationary or changes in freight regulations that have impacted various prices in our inputs. The operational efficiencies is just more miscellaneous stuff around just various smaller one-timers or around different plants.

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

Right, right. So I mean none of that I guess is really price pressure related to overcapacity per se, right? I mean the sweeter demand and the rebalancing gets you back, I guess, the industry back in balance on that piece. Is that the right way to think about it? I mean all of these things aren't easy to get back and it takes time, but this is not a structural competitive issue. Like none of these buckets seem to me like they are related to structural competition increasing and pricing coming down type of issues? So is that a fair statement?

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

Well, I mean, I think the one thing that Jim did highlight though is that when we look at our sweetener volumes and particularly sweetener that's probably sold in the beverages, we've stated for a long time that we see that volume declining over time. So we do expect about $20 million of the impact '18 versus '17 in North America due to sweetener volumes to be structural, okay? So now we're offsetting that as we transition. We ceased wet milling at Stockton, and we transitioned that volume to other plants. We'll get -- that will be about a $6 million to $9 million type of annual savings. But right now, in front of us, we would look at about $20 million of impact '18 versus '17.

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

Got it. And just one last one on the contracting. So the point you're making is net corn costs. Whatever people's views are, it's a bit higher than that. And what we have heard about contracting is that pricing is up, and it depends on which product, obviously, to estimate how much. But would it be your view that -- what is your view on capacity utilization? Because I'm guessing you don't want to comment on margins outlook for next year. But it's capacity utilization, what's the view this year versus last year as you're contracting?

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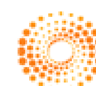

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James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Yes, I think that what I would like to say in relationship to capacity utilization is that we believe with the Stockton closure that, that certainly helps from a standpoint of our network from an industry balance standpoint, and we believe that the industry continues to operate at high capacity utilization rates.

Operator

Our next question comes from the line of City Investment Research. Please state your name.

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

It's David Driscoll. I wanted to follow on these North American questions. So the biggest topic that I hear from some of the competitors is that Ingredion is just more exposed to the freight market, the truck market, in that you guys -- you have a different cost structure than they do. So to be honest with you, I'm not clear on how you will recover all those freight costs in light of the fact that, that cost moved so much relative to rail? And does this put you in a difficult spot in recovering those freight costs?

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

Let me take a shot at it and then let me ask Jim to add some additional commentary. So because we have, I think, relative to -- or the other players in the industry, a large specialty starch business that is shipped in dry -- by dry van. Dry van was the first freight category out of the gate in 2018 to get hit with pretty steep increases in price. And we see though continued freight inflation that's going to impact -- that is impacting rail and will impact ocean freight as well. But because of our specialty starch dry van shipments being relatively larger probably in comparison to other industry players, that's been a headwind for us. We have made significant progress in working with customers and our contract terms have been updated with new freight rates where possible. We're also enforcing longer lead times, which; should mitigate the risk, and of having to enter the spot market, for example, for last-minute shipping. And we're working very hard to mitigate the impacts that we experienced this year, but also certainly there's going to be additional freight inflation that the industry's going to experience. And we're seeing that in some of the earnings releases I think in the CPG world right now. So but this has been an intense area of focus for us starting immediately in quarter one. And I would say we've actually made very good progress working with our customers to mitigate some of the impacts, and are continuing to do that. And then will also move as it relates to pricing for 2019 as well. Jim, would you want to add anything?

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

David, I mean, I'll just follow up, this is Jim Gray, that when you're thinking about the value of food starch coming into a customer and kind of where that sells for on a price per ton basis, the cost of the freight is a smaller proportion of that total cost of the customer. So obviously, if there is changes there, you can also -- I think there's -- we have more confidence that those can be mitigated some way. There's either ways you can change between us and our customer where inventories are held to help make the transportation cost more efficient and lower and/or the value of -- or the cost of the freight change relative to the cost of the final product is lower. I think if you move to more of a syrup business where you have tanker trucks or rail car tankers. There, the freight cost is more expensive given the uniqueness of the asset. And so there I would expect to see if you have freight inflation that it's going to impact it'll be more of an issue in terms of managing through customers.

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

Two quick follow-ups. On the sweetener volumes in North America, the one point that I find a lot of investors keep asking me questions about is that it's been widely known for years that high-fructose corn syrup demand is going down. You guys have called it out though this year as like a significant headwind, but your competitors, they haven't. So what's the difference between Ingredion's sweetener issues and issues in the industry

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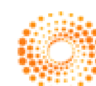

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recognizing that volumes have been in decline for many years now? So I guess I'm not perceiving sensitivity on how much your sweetener volumes went down, and why it became such a headwind? And then similar in this thing could you just wrap up with North American volume outlook? Is this a flat volume market for you guys on a go-forward basis?

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

Yes, let me take your first question and then let me have Jim answer the last question. So this is actually also something that we tried to provide some perspective on last quarter. Because it is a very important question and it's a very good question. So let me try to put the sweetener market fundamentals into the context. Total sweeteners volume for industrial and food usage has been flat over the last few years, but there's definitely been growth for industrial glucose usage such as is it used as a feedstock for renewable chemicals or as a fermentation substrate. However, HFCS has continued to decline. And I do want to highlight something that HFCS decline this particular year for the industry is twice the rate of -- in previous years. So it is declining this particular year at a little bit for a steep decline. In addition, we, Ingredion, produce sweeteners primarily for food grade applications. And each industry player is impacted differently by their mix of sales for industrial use like I just described versus food end uses, and also across the customer base and geographies. So we are going to be impacted differently by say other industry players. But I think it is accurate to say that over the last number of years, sweetener volumes are -- overall the category is flat. HFCS is declining. Its decline this year is at an increased rate in comparison to previous years. And over this period of time, uses for industrial applications have been actually increasing commercial and offsetting some of that HFCS decline. And we're impacted differently because we're primarily food, and again where we are located with customers and geographies is going to be different. So, Jim, I'm going to ask you to give a comment on the volume outlook.

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

Sure. David, overall -- I think your question was, is the North America volume outlook flat? I would say that it actually improves as our product sales mix changes over time. Year-to-year, as corn changes, we're going to pass through changes in corn. So you can take that out of the equation fundamentally. As we sell more specialty products, we're going to see higher average sales prices per ton, and that's going to actually improve our product sales mix over time. And we will see sales growth in North America from that.

Operator

And our last question comes from the line of Goldman Sachs. Please state your name.

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

Adam. Do you hear me?

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

We can hear you now.

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

I apologize. Jumping between conference calls. Can we -- just the first question on capital deployment. This -- the big step up in buyback in the quarter. Should we see there's any signal about the appetite or the attractiveness of M&A in the current environment and the opportunities that you might see to grow the specialty business inorganically today?

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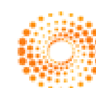

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James P. Zallie - *Ingredion Incorporated - President, CEO & Director*

Yes, so the share repurchase authorization from the board and the accelerated share repurchase I think just shows the confidence in the value of the company and the value of the stock. But we have several specialty growth platforms that we're pursuing, which we have M&A opportunities to invest, and which will help accelerate our specialties growth position for the future. So we believe our solid cash generation enables us to execute M&A and specialty investments, while being mindful of the return of capital to shareholders. So we're pretty confident regarding the cash deployment aspect of things.

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

Okay. And then just to follow up on some of the profit bridge details that you gave, thinking about '19, and those were very helpful. The material kind of inflation bucket, the $40 million versus 2017 baseline, I think, Jim, your comments were you were working diligently to recover those. I just want to be clear that you were expecting additional inflation on top of that $40 million bucket in 2019? So is the goal to be getting pricing to recover the $40-plus million whatever incremental you get? And then if so or how do we think about how Cost Smart is a part of that or incremental to that recovery?

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

Let me provide the clarification question and then let me turn Cost Smart over to Jim Gray. So the freight bucket, this freight inflation we've experienced this year and the inflation we talked about, say, packaging and chemicals, et cetera, additional, and then in addition, we had commodity margin pressures that we talked about as well. So that's a bucket that we are working aggressively from a standpoint of offsetting and to mitigate as we head into next year. And we are making progress against a number of those and talked about of the freight specifically. Let me turn it over to Jim to talk about the other aspects.

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

Well, just to follow on that, I do think, Adam, that you characterized it correctly. There was in-year inflation and there is some commodity margin pressures that have impacted us in '18. At this point, in the middle of contracting season, et cetera, it's really an unknown to us. We will comment more as we get into next year. I think with regard to Cost Smart, specifically though, we are taking actions in Cost Smart against our SG&A, our operating expense of globally, and we are very much thinking about what's the wage inflation that we'll encounter in each country. How are we offsetting that? How are we actually trying to restructure and move to a leaner, more streamlined and kind of agile support function as well as a supply chain function here that kind of impacts our SG&A as a -- in total and as a percentage of our net sales as we go forward.

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

And I just want to be clear because there are the two parts of the Cost Smart. There's the SG&A, part which is very clear. The $40 million bucket that you talked about in the prepared remarks, those seem like most exclusively in COGS or at the gross profit level? And there's kind of gross productivity actions within Cost Smart as well. And so on top of the $40 million you've experienced in 2018 relative to the '17 base, we would think that there would be incremental inflation year-on-year. And I'm just trying to make sure as I start thinking about the '19 versus '18 bridge kind of is Cost Smart going after the inflation '18 -- '19 versus '18, or do you think you can actually recover the '19 versus '17 inflation in kind of gross?

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

Well, so in the $40 million kind of inflationary bucket that we highlighted. So we talked about freight, which in our accounting is actually above net sales. And then also the commodity margin pressure is really more against our cost of corn. And so within that overall bucket, you do have some manufacturing input inflation issue that we're trying to address as we think about pricing and contracting for 2019. Cost Smart builds upon that as we go forward for 2019, 2020, 2021. Cost Smart cost of sales is really more trying to look at how we affect kind of permanent changes within

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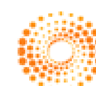

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our manufacturing expense and with overall how the network comes together. So I think some of that bucket that you've attributed hits us in different line items within our P&L. But the Cost Smart works from our '18 base forward.

Operator

And that is all the questions that we have at this time. I'm turning it back over to the host.

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

I'd like to thank you for your time today. If you have any follow-up questions, just simply give me a call. Thank you.

Operator

And ladies and gentlemen, that does conclude our conference for today. Thank you for your participation and for using the AT&T executive teleconferencing services. You may now disconnect.

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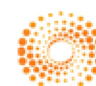

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