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INGR - Q2 2017 Ingredion Inc Earnings Call

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OVERVIEW:

Co. reported 2Q17 reported operating income of $211m and reported EPS of $1.78. Expects 2017 adjusted EPS to be $7.50-7.80.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Ladies and gentlemen we would like to thank you for standing by and welcome to the Ingredion Second Quarter 2017 Earnings Conference Call. (Operator Instructions) And as a reminder, today's call will be recorded. I would now like to turn the conference over to our host and facilitator, Ms. Heather Kos. Please go ahead.

Heather Kos

Good morning, and welcome to Ingredion's Second Quarter 2017 Earnings Call. Joining me on the call this morning are Ilene Gordon, our Chairman, 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 will also refer to certain non-GAAP financial measures, including adjusted earnings per share, adjusted operating income and adjusted effective tax rates, which are reconciled to U.S. GAAP measures in Note II Non-GAAP Information included in our press release and today's presentation appendix.

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

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

Thanks, Heather and let me add my welcome to everyone joining us today. We appreciate your time and interest. I am pleased to announce Ingredion ended the quarter with solid growth in adjusted operating income and adjusted earnings per share. Volumes grew by 1% driven by acquisition-related and specialty volumes. The TIC Gums, Shandong Huanong and Sun Flour rice acquisition integrations are underway. We remain excited about the pipeline of projects and customer demand for these ingredients as well as synergy opportunities.

Now let's spend a moment on each region's performance in the quarter. Operating income in North America was $181 million, up $21 million from last year. Overall volumes were up 2% driven largely by our TIC Gums acquisition as well as organic growth in our specialty ingredients. Mexico core volumes were down for the quarter due to customer rebalancing, however, specialty ingredient sales were strong. Continuous improvement initiatives and lower input costs continue to drive good operational efficiencies throughout the region. Additionally, we lapped last year's plant maintenance, which will occur in the fall of this year. The TIC Gums integration continues as planned further enhancing our texture capabilities and enabling us to deliver custom solutions faster to small and medium-sized customers.

In South America, operating income was $4 million, down $10 million from last year. The macroeconomic conditions continue to be challenging in the Southern Cone, especially in Argentina. Pricing actions, good cost discipline and continuous improvement projects partially offset the temporary higher cost from the interruption of manufacturing activities in Argentina. The new labor agreement reached on June 1, 2017, was an important organizational restructuring action to become more cost competitive. In 2017, we expect South America to maintain a tight focus on cost and network optimization in addition to our ongoing focus on specialty growth. For the short term, we expect the materialization of some operating efficiencies. In the longer term, we believe the underlying demographics are positive for the future and believe we are well positioned to take advantage of an economic recovery when it materializes.

Moving along to Asia-Pacific. The region delivered $29 million of operating income, down less than $1 million from last year. Overall volume was up 10% versus last year and specialty sales were particularly strong in Korea and Southeast Asia. Price/mix was affected by our decision to diversify our core customer mix and repurpose capacity to higher margin sweetener blends. Our Shandong Huanong and Sun Flour rice business integrations are going well. Our Shandong cost synergies are on track for 2018 and the demand for our rice-based ingredients is strong.

Finally, the EMEA region reported operating income of $29 million, in line with last year. Favorable price/mix was offset by lower volumes due to Ramadan timing in Pakistan, which occurred in July of last year and currency headwinds in Europe.

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

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

Thank you, Ilene. Good morning, everyone. Let me start by covering the highlights of the income statement. Net sales were flat for the quarter. Higher volumes were offset by lower price/mix. Gross profit was higher by $18 million as a result of margin expansion in North America and the higher volumes from the inclusion of the TIC Gums acquisition and specialty ingredients. Reported and adjusted operating incomes were $211 million and $221 million, respectively. Reported operating income was lower than adjusted operating income by $10 million. This difference is largely related to pretax restructuring charges of $6 million in Argentina for employee severances as we took actions to improve efficiencies and lower operating cost. And we had a pretax expense of $4 million for integration and acquisition costs, including the fair value mark-up of acquired TIC Gums inventory. We also recorded $1 million of nonemployee related charges for the launch of a finance transformation project. We are consolidating certain transactional activities in the U.S. and Canada and to a shared service center. The purpose is to advance our finance capabilities while setting up better leverage in our cost structure to support our strategic growth initiatives. Our reported and adjusted earnings per share were $1.78 and $1.89, respectively.

Moving on to the net sales bridge. Our sales were flat versus last year. Volume and foreign exchange contributed $18 million and $2 million, respectively. This was partially offset by $18 million of unfavorable price/mix. Our price/mix change was largely driven by the pass-through of lower raw material costs.

As we look more closely by region, you can see unfavorable foreign exchange affected North America slightly as well as EMEA, predominantly driven by the British pound. Volumes were up in North America and Asia-Pacific. In North America, volume was up driven by our TIC Gums acquisition as well as specialty ingredients. In Asia-Pacific, volume was up given our specialty capacity expansion. However, price/mix was down due to pass-through of lower raw material costs as well as our decision to diversify our core customer mix in Korea.

In South America, volume was down due to the manufacturing interruption in Argentina and price/mix was down driven by lower raw material cost pass-through.

For the quarter, reported operating income increased $13 million, while adjusted operating income increased $10 million. North America posted strong results due to margin expansion driven by operational efficiencies, growth and acquisition and specialty related ingredients and the lapping of last year's plant maintenance.

South America operating income decreased by $10 million. The decrease was largely a result of Argentina's difficult macroeconomic conditions and the strike in Argentina, which interrupted manufacturing and resulted in temporary higher costs.

Asia-Pacific was down less than $1 million and EMEA was flat despite the headwind from Ramadan timing. Corporate costs were flat for the quarter.

We'll wrap up the discussion of the quarter with earnings per share. On the left side of the page, you can see the reconciliation from reported to adjusted. On the right side, operationally, we saw an improvement of $0.09 per share primarily the result of volume of $0.08 per share due to acquisition and specialty related ingredients, with a lesser benefit from foreign exchange and other income. This was offset by a margin impact of less than $0.01. The lower margins were driven by Argentina's labor strike.

Moving to our non-operational items, we recognize the benefit of $0.07 per share for the quarter. Our adjusted tax rate was lower, contributing $0.06 per share benefit. The lower tax rate was largely driven by the effect of depreciation in the Mexican peso and resultant valuation of U.S. dollar-denominated balances for tax purposes. Our shares outstanding reflected a per share benefit of $0.02. These benefits were offset by higher financing costs of less than $0.01.

I'm going to move fairly quickly through the year-to-date figures. Net sales were up year-to-date. Higher volumes and foreign exchange more than offset lower price/mix. Gross profit was higher by $31 million as a result of margin expansion in North America and higher volumes from the inclusion of the TIC Gums' acquisition and organic growth in specialty ingredients. Reported and adjusted operating incomes were $406 million and $433 million, respectively. Reported operating income was lower than adjusted operating income by $27 million. This difference is largely related to pretax restructuring charges of $17 million in Argentina from employee severance as we took action to improve efficiency and lower our operating costs and we had pretax expense of $10 million for integration and acquisition costs, including the fair value mark-up of acquired TIC Gums' inventory. Our reported and adjusted earnings per share were $3.46 and $3.77, respectively.

Moving on to the net sales bridge. Our year-to-date sales were up versus last year. Volume and foreign exchange contributed $94 million and $50 million, respectively. This was partially offset by $49 million of price/mix. Our Price/mix was largely driven by the pass-through of lower raw material costs.

As we look more closely by region, you can see unfavorable foreign exchange affected EMEA, predominantly driven by the British pound. Volumes were up in North America, Asia-Pacific and EMEA. In North America, volume was up driven largely by our TIC Gums acquisition as well as specialty ingredients. In Asia Pacific, volume was up given our specialty capacity expansion. Price/mix was down 2% largely driven by the pass-through of lower raw material costs in 3 of our 4 regions and the diversification of our core customer mix in Asia-Pacific. For the year, reported operating income increased $8 million, while adjusted operating income increased $21 million. North America posted strong results due to margin expansion driven by operational efficiencies, growth in acquisition and specialty related ingredients and the lapping of last year's plant maintenance.

South America operating income decreased by $13 million. The decrease was largely a result of Argentina's difficult macroeconomic conditions and the strike in Argentina and resulting temporary higher costs. Asia Pacific and EMEA were up $1 million and $2 million, respectively. Corporate costs were flat.

Moving to the earnings per share. Changes from operations saw an improvement of $0.19 per share, primarily the result of volume of $0.26 per share with a lesser benefit from foreign exchange of $0.04 and $0.02 from other income. This was offset by a margin impact of minus $0.13. The lower margins were largely caused by South America with Argentina's difficult macroeconomic conditions and labor strike with temporary higher costs affecting the region.

Moving to our non-operational changes. We recognize a benefit of $0.07 per share. Our adjusted tax rate was lower contributing $0.12 per share benefit for the same reasons I explained in the quarter earlier. Our shares outstanding had a per share benefit of $0.02. These benefits were offset by higher financing cost of minus $0.07 caused by a higher debt balance and higher interest rates.

Turning to our guidance. We reiterate our anticipated 2017 adjusted earnings per share range of $7.50 to $7.80. This guidance excludes acquisition-related, integration and restructuring costs as well as any potential impairment costs. We expect net sales and volumes to be up from 2016, and we expect continued growth in specialty sales. We anticipate that foreign exchange -- the impact of foreign exchange will be net neutral overall. We expect corporate expenses to be up year-over-year due to continued investments in our administrative processes to strengthen our capabilities and drive future efficiencies in our business. We expect financing costs for the back half of the year to be in line with our financing cost during the first half due to higher interest rates on our floating rate debt and our refinanced maturities. Our adjusted effective annual tax rate is expected to be approximately 29% to 31% versus an adjusted effective rate of 29.4% in 2016. Although we experienced a lower rate in the first half, it's important to note that the Mexican peso appreciation was the predominant driver of that lower rate. We expect total diluted weighted average shares outstanding to be in the range of $73.4 million to $73.8 million for the year.

In North America, we expect net sales to be up. For the full year, we expect operating income to be above 2016 levels with improved product mix and margins. South American net sales are expected to be flat to down versus the prior year given the pass-through of anticipated lower raw material costs and the temporary interruption of manufacturing activities in Argentina during Q2, partially offset by favorable foreign exchange. We anticipate continued slow activity in Brazil and Southern Cone. In Argentina, we finalized an important organizational restructuring enabling a more cost competitive position going forward. Throughout the region, we continue to actively manage our costs to drive efficiencies and offset inflationary pressures. And we continue to look at optimization opportunities. Overall, we expect operating income in South America to be flat to down relative to 2016.

Asia Pacific and EMEA should continue to deliver operating income growth. We expect the Asia Pacific business to be negatively impacted by currency headwinds associated with a stronger U.S. dollar relative to last year as well as the continued diversification of our core customer mix. But we expect to overcome these headwinds with continued growth in specialty ingredients and good cost management. We expect our EMEA region to have flat net sales compared to prior year. We anticipate modest growth in the European business, fueled by our specialty ingredients portfolio. However, we expect currency headwinds to partially offset the anticipated improvement. Pakistan is expected to continue its volume growth and drive for continued efficiency gains. We continue to monitor the political environment and potential risks to our business.

Moving on to cash flow. Our year-to-date cash provided by operations was $302 million. During the year, we deployed cash in the form of capital expenditures, dividends, share repurchases and acquisitions. Our year-to-date capital expenditures of $144 million were up $19 million from last year primarily driven by growth and cost-savings initiatives. We expect cash from operations in 2017 to be in the range of $750 million to $800 million, which is down slightly from our previous estimate due to the Argentina organizational restructuring and finance transformation project. We expect to invest between $300 million and $325 million in capital around the world in 2017 to support growth as well as cost and process improvements. Importantly, we have a proven track record of both reinvesting and returning capital to shareholders and we expect to continue this in the future as we concurrently explore M&A opportunities.

That brings my section of the presentation to a close. I'll turn it back to Ilene.

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

Okay. I'm pleased with our results this quarter. From a strategic perspective, our business model and blueprint for growth are working. Our momentum continues on a positive trajectory, and we continue to transform the business. Our global footprint and customer diversity balance, regional and sector risks. Our innovation capabilities and portfolio of on-trend ingredients give us a competitive advantage. We continue to grow our on-trend specialty ingredients, expanding our texture, wholesome, sweetness and nutritional offerings. And our network of Ingredion Idea Labs enables us to collaborate side-by-side with customers, adapting innovations from country-to-country, while customizing solutions to local preferences and tastes. From our foundation of operating excellence, we continue to optimize our cost structure for the future, while investing for growth in our specialty business. With our strong balance sheet, we expect to continue deploying our capital for growth in acquisitions as well as dividend and share repurchases to deliver excellent shareholder value.

And now, we're glad to take your questions.

QUESTIONS AND ANSWERS

Operator

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

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

Just 2 quick questions. One is on the guidance, Jim. I think last quarter, the guidance was a headwind for FX of $0.10 to $0.20, now it's neutral. But you haven't bumped up your adjusted earnings guidance for the year. So is that just a pass-through mechanism that was never really economic to begin with? Or is it something else fundamental to the business? And, I guess, the second question is, what's your outlook for the pricing power that you have and the industry has in corn sweeteners going into annual negotiations in the fall. You've talked a lot about high-capacity utilization and the need to return cost of capital. Is everything pretty much consistent with that? And do you feel confident that -- corn prices are up a little bit, that the industry can pass that through?

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

Sure, thank you for the first question, Rob. We had guided $0.05 to $0.15 headwind on FX prior, now we're more neutral. I think we look at a range of plus $0.05, minus $0.05 perhaps on that. It is really just an FX pass-through on that impact. I think your second question, as we think about the industry, we're really looking at the balance of utilization within the U.S. against corn wet milling and how the industry is balanced. I'd say that we're modestly positive going into the year. I think it's helpful to be watchful of corn -- corn price and the run-up. Obviously, if corn runs up and that sets a new underlying level for the price of our sweetener products to our customers, that creates a bit of inflation, which can cause customers to look for other substitutes. But right now, I think given the outlook for the carryout of the corn market in the U.S., I think it's going to be an abundant corn crop.

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

I guess, what I would add is, the utilizations are high-80s right now and given that corn prices are really a pass-through for us, we continue to feel positively about the environment.

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

Okay. And when you say substitutes, do you mean in North America as a whole or is it like Mexico that you're referring to? The U.S., I imagine, the switching costs are a little higher between corn and sugar.

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

Switching costs, I think in the U.S., are higher between a corn sweetener and sugar. Yet I think Mexico does balance demand for HF 55 and liquid dissolved sugar.

Operator

Our next question will come from the line of David Driscoll of Citi.

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

I just wanted -- I have a couple of things, but I wanted just to do a quick follow up on Rob's question on the foreign exchange. I don't think I've ever heard it described that way, Jim, that it's a pass-through. I mean in so many years in the past, we've seen foreign exchange as a distinct headwind, and then pricing was necessary to be put into place in different geographies to offset foreign exchange and it never happened on a real-time basis. It was always 9 months or something delayed. Can you -- given your description that it's just a pass-through and that this change to your FX forecast has no real impact, could you just talk about what's changed in the business from how we've seen previous instances of big foreign exchange impacts hit EPS?

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

David, I don't know if much has changed. Maybe what I'm describing is just a shorter cycle. As we've seen corn prices move if they're U.S. dollar-denominated, I think our pricing cycles can be anywhere from kind of 6 to 12 weeks. So what we're trying to do is as corn is changing on a -- if it's globally priced in U.S. dollars, and that's moving, then we're trying to make sure that the contracts and countries where we don't hedge are updating maybe on a slightly tighter cycle. You mentioned more like 6 to 9 months, I would say we try and lease manage that to more like a 3-month type of cycle.

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

Maybe we can follow up on that off line. I have a lot of questions right there. I would just maybe ask, does this at least improve your confidence given what's happened on foreign currencies, I mean, is there any tangible effect that you guys would call out to the Street?

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

Well, the most immediate impact has been in the -- are in the Brazilian real. So we were positive on that, and then we've had some political turmoil recently in the last month. And so we're still a bit kind of wide-eyed and cautious about how Brazil's political situation turns out and what impact that has on the real. But for the Q2 where we've seen the benefit has been in the real. I would mention as well, now as we go into second half, the lapse on the British pound and the euro will start to subside, right? So most of our impact last year was in first half.

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

Okay. Ilene, just one for you on South America. I don't really want to put a timeframe on this. Can you just talk to us about the longer outlook here for the South American operations. It's been a very disappointing operation. I mean, you're not even close to your cost of capital in this region. What type of cost reductions can you expect, or can we expect, for the company to achieve in '17 or '18 or whatever frame -- timeframe you want to put on it? And then secondly, what other major metrics are you looking at to really indicate that this business has the potential to turn around and become the business that we saw back in 2012 or that timeframe?

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

Well, good question. First of all, I look at our footprint today, and it's a much better footprint than it was a few years ago. If you recall, we shut down 2 smaller facilities in Brazil that were inefficient and so we've moved that capacity to the remaining 4 facilities. So we believe that we have a stronger footprint in Brazil. And in terms of the Southern Cone, with the most recent labor action, we've been able to take cost out of the system and that has been a real positive. And then in Columbia, we've continued to invest in a very good economy and GDPs are better than they are in other parts of the continent. So I think that our footprint in the total continent continues to be excellent and that the types of metrics that we look at, when we look at the demand, and certainly the GDP econometric type forecasting, is certainly an important metric. But our strategy is to grow in specialty products everywhere. And actually, in South America, even though it's a very small base, we've been very excited about what we see about the consumers demand for healthy ingredients and we expect that in the future to continue to grow. And so we have developed solutions in South America, which we have actually borrowed from other parts of the world, Ingredion Idea Labs, and then localized them for the local taste, whether that's in the dairy area or in some of the sweeteners. So we see some opportunities there, both in the short-term and the long-term. So I think it is a matter of the economies coming back, they will come back. But with our strong position throughout the continent with our excellent factories, operating excellence, we've continued to work on that and optimize costs, and then the growth of specialty, we are optimistic about the future in South America.

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

Are you able to quantify any of the cost savings activities, just to give us some color here on the strength of the actions that management's taken to improve the ops?

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

Well, the cost savings, I'll start on that and then turn it over to Jim. But if you recall, when we shut down the 2 Brazilian facilities, we talked about cost savings that we'd experience in 2017 and that number was in the order, I believe, of $5 million to $6 million. We have not announced any specific cost savings going forward. But of course, if you look at the below the line costs that we've taken for the strike, of course, those won't be repeating next year, and there are actually some above the line costs inherent with labor actions that also are kind of a one-time event. But Jim, I know you might want to add to that.

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

Yes, to add color. If you look at what South America is down, first half versus last year, a large, large portion of that is some of the temporary costs that we had to incur for the labor action in Argentina, so security and warehousing and such. I would also say then that the restructuring costs that we've taken relative to the Argentina action we're probably going to get on an annual basis, and we're estimating about $12 million in terms of run rate savings on labor against that. So we would see those 2 step change improvements. We would expect those improvements as we look to 2018. We'll get a little bit of that in the second half, David, right, because those positions have been terminated. And then we'll get the incremental as we roll into 2018.

Operator

We have a question from the line of Ken Zaslow of Bank of Montréal.

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

Sorry, I've got to belabor this point. I think that's what analysts do, unfortunately, but I don't understand this. You guys exceeded expectations 2 quarters in a row and reduced your FX. Is there something that is less good going forward that kept you in your guidance? Or is there something to think about? Are you on the higher end? Is there any change to it? It just seems, again I apologize for belaboring it, but it seems a little strange with such good results for the last half as well as lower FX.

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

I'll start off and then I'll turn it to Jim. Ken, it's a good question and we feel good about this year. But as the last question that we just talked about, South America is still one of those unknowns as it relates to the economy. We feel good about our operations and our focus there and our growth in specialty. But there aren't any green shoots in the economies yet to make -- put us at the higher end of the range. So we feel very secure in terms of our range overall. But I would say that you look at EMEA, Asia-Pac, good; North America, strong. It's just that South America, we're excited about what we've been able to accomplish in the Southern Cone and Argentina. Brazil actually, I'm starting to see the GDP for the first time for 2017, it has a 0.3%. I mean, it's barely positive. And we look that we've hit bottom in Brazil, a very important country but that could be better but it's barely positive. So I think that's the part that we're being conservative about. And so I know, Jim, we've looked at the different ways to look at it. And so I'd say that South America is what kept me from being overly exuberant.

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

Yes, Ken, I think that maybe to add color on the FX and the rates. Really, the change in the real is probably the single-largest determinant in our view on FX. So we're still full year think the euro year-over-year and the pound, particularly the pound, are the weaker. We're still seeing devaluation in the Argentine peso. Mexico, we're U.S. dollar-denominated in our business, but we still get some impact on our tax rate depending upon whether or not the peso is stronger or weaker relative to the dollar. But really, the toggle has been on the real and whether or not we believe the real is going to continue in the $3.20, $3.25-ish range or it's going to weaken to more of the $3.40 range. So we've been a little conservative, I think on the real in our forecast for the year, yet we're still balancing that with the political situation there as well.

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

May I ask a bigger picture, longer-term question? If I think about North America, that has exceeded, I'm assuming your expectation as well as most people's expectations. Can you continue to grow that off the current base outside acquisitions?

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

I'll start off and then turn it to Jim, but we've added capacity in specialty products in North America. So as an example, we've talked about this specialty asset in Indianapolis that has just only come on stream in the last 6 months. So we're excited about qualifying customers and growing there. So as it relates to specialty products, absolutely. We would expect to be able to continue to grow them to mid- to single digit -- high single digit growth in North America, which is a terrific market where consumers want healthy ingredients, they'll pay more for non-GMO, texture solutions, special sweeteners. So that's where we're really focusing a lot of our energy. And of course, Mexico GDP growth is better than the normal, closer to 2% or more when you look at the next couple of years. So we see opportunities there. Jim, I don't know what you want to add there.

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

The corollary to that is to the extent that we have business that is focused on kind of our core sweeteners, we have to be very watchful of our costs and continue to drive our continuous improvement against our manufacturing expense and our asset utilization that's against core sweeteners.

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

And my final question. Just interesting that throughout the presentation, you made a couple of references to either rebalancing clients -- customers in Mexico or diversifying customers in Asia. What does that mean? What are you doing? And can you give examples of how broad that is and what the impact is and is there anything to read into that as margin enhancing or anything?

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

I think that maybe the more -- the example that we should talk a little bit is in Korea where we have a customer base where some of its focused on core, kind of high fructose. And as we move away from customers that are in high fructose towards blends or blends of sweetener that use isomaltose or other perhaps stevia that deliver a calorie reduction and help the customer solve identified sugars or added sugars on the label, it moves us towards kind of a better blended mix. So we may be suffering as we see the high fructose roll off, and we're setting ourselves up with headroom capacity in our finery to continue to develop a newer product line that may take us 6 months to 18 months to develop and sell in. But we need that headroom capacity in order to make that blend and have a more differentiated product that is more on trend with changes in the consumer scene.

Operator

Our next question will come from the line of Brett Hundley of Vertical Group.

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

Jim, I actually just wanted to follow-on real quickly on an answer you just gave on Korea. So when I look at your business in Asia, volumes, very solid, but your margins kind of slipped a little bit sequentially and year-on-year. And so as I think about you guys diversifying your customer mix, you just talked about 6 to 18 months lead time, to kind of change over a bit. Should I think about your margins in that region under a little bit of relative pressure during that time and then maybe more improvement at the end of that timeframe, is that the right way to think about that?

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

I think that's the right way...

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

All else equal.

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

Yes, yes.

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

Okay. If we can just talk about South America for a minute. You guys continue to project flat to down income for 2017. And, I guess, I'm really curious about the assumptions behind the word flat, or the scenario flat. You talked about some savings coming in, in the back half of the year related to Argentina. But can you go through maybe just the scenario where you guys do end up flat just given the really tough H1 that's been in place? I'm imagining that it's going to take time for volumes to come back in Argentina. I'm curious about your corn situation in Brazil and elsewhere and how long you are there. So maybe just some granularity on how you guys would end up flat.

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

I'll start off and then turn it to Jim. When you think about -- when I talked about Brazil being at the bottom, there is a forecast for their GDP to be slightly up for the year. And so when you look at the activity in Brazil for the second half, there is some positive trajectory there. And when we're well situated with our capacity, with our team, with our focus on our customers, and with the growth of some specialty, albeit from a very small base, there is some upside in Brazil for the rest of the year. As you mentioned on Argentina again, we are now moving towards some of that cost reduction that's been achieved from the labor side and other productivity improvements, which would add to that second half. And then of course, in Colombia, where the economy -- the GDP is really considered over 2% for 2017, we've gotten through some, I don't know, wet periods of time there, and the demand for specialty in Colombia and overall, pretty decent economy that there are parts of South America that could actually add more than they have in the first half. But Jim, I don't know what you want to add to that.

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

Maybe just as a base for understanding, Brett, for 2016, about 2/3 of our operating income came in the second half. So there is -- it's hard to see, but there is a bit of seasonality to the customers that we serve. In Argentina, our core business is just really focused on beverages. I think, in Brazil, we've mentioned in the past that we have a fair amount of customer servicing in the brewery business. So we get a bit of seasonality as they enter their spring and summer. So first just kind of ground that, because that -- if you don't recognize that as a starting point then your healthy skepticism on getting to flat is warranted. In addition, I would go back to the things that Ilene just mentioned in terms of, we see a nice balance of our margins in Brazil relative to corn and relative to where the real is. We've had a chance to have a little bit of stability and kind of catch up, I think in terms of some of the margin pressure and dollar change in the cost of corn that we had in prior quarters. And then all of the actions that we've taken in Argentina to become more cost competitive.

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

That's helpful. So is it overly simplistic to basically say that the macro in Brazil is kind of the main swing factor between flat and down?

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

I would say that it's the macro -- and you're right, I mean, the cost actions we've taken, we get either way but it's always better when the economy is on the way up. So yes, the economy is a swing factor.

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

Okay. And then just lastly for me, Jim, as I revisit guidance here for you guys, if I try and break apart Q3 and Q4, do you guys view Q3 as kind of a real tough comp? Do you guys think that you can see pretty good earnings growth in both quarters? Can you direct us a little bit to the extent that you can?

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

Brett, we don't really think about specific guidance on a quarterly basis. I just think that some of what we've seen in terms of strength in North America will carry through in Q3, and then North America tends to be a little slower in Q4 just seasonally. And then we're looking at some of the strength that we mentioned in South America in the second half.

Operator

Our next question will come from the line of Akshay Jagdale of Jefferies.

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

So I wanted to ask about the core customer rebalance issue in Mexico. Can you talk about what that is, and if that has any connection with the political environment? And so that's my first question.

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

Sure. I think what we experienced in Mexico in Q2 was we had -- in Q4 of last year, we had planned on building inventories, mostly in starch anticipating new contracts that we would have, primarily in brewery as we completed our expansion in San Juan del Rio in the spring and as we completed that, we wound down some of those inventories that we had built. We are anticipating some take up from some specific customer sites. And there is some exchange going on between some of the customers buying different brewery sites, or a brewery site, and moving those around in terms of balancing their production. So I think that we kind of have a temporary just rebalancing here that's going on as orders between 2 of the largest brewery customers are kind of getting sorted out, given the history of ABM Baz and Modelo.

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

And so I wouldn't call that a political reaction, no. Just customer strategies.

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

Yes.

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

So that's helpful. Can you give us like order of magnitude impact for that? And it sounds to me, and we can follow-up off line, that that seems like a timing issue related to your customer strategy rather than anything else, meaning at some point, whatever that volume is it's going to come back. So am I interpreting that correctly? And can you help us -- give just round numbers quantify what that might be, how big that impact was?

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

Yes, I mean, we wouldn't call out something specifically in terms of numbers, but as we see it as temporary, this may be Q2 or may be into Q3. But we see the rebalance and we don't see any significant change in the customer relationships nor the strategic attractiveness of where we manufacture and where we ship from for our grits.

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

Okay, that's helpful. And then just looking at the guidance range, half the year is over in the books and you still have a pretty wide range there. You did talk in depth about the range of options in South America. But what may -- typically at this time, I think your range is tighter, so can you help me understand if both ends of the range are truly in play right now, or you're trending one way or the other based on what we've seen so far this year?

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

I think on -- fair enough question. I think on the lower end of the range, what's still is out there is we do want to see the recovery of our customer base in Southern Cone, following the shutdown of our 2 facilities. We're also watching what happens in terms of NAFTA. I think that we're a little bit more clear on the limited set of changes being proposed, but still we're thoughtful on that. More, in particular, not necessarily in the regulation, but any perceptions of investment into Mexico and whether or not Mexico's GDP growth softens in the wake of slightly higher inflation rates in Mexico, we're seeing inflation maybe north of 6% for the second half, don't necessarily see kind of necessarily personal incomes keeping up. So we're just watchful of overall take away in Mexico in the second half. That's really I think the 2 or 3 things that are kind of on our minds. We also actually mentioned in Brazil and resolution of whether or not Temer is able to put through some reforms that generally stimulate GDP. I think we're a bit cautious on that now. I think on the high-end, we do see really nice momentum in North America. And we're still anticipating growth for both Asia-Pac and EMEA, and really, kind of the interesting one for us will be just to see kind of how much North America -- or how much South America recovers and goes into summer.

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

And we did narrow the range at the end of the second quarter. And you're right, it's halfway through the year, but I think Jim has laid it out. I think it's a very balanced -- we feel pretty balanced here.

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

Okay, just one last one, Ilene, it's for you on specialty. It's a bit hard to know exactly what's going on quarter-to-quarter for us. So I'm just looking for some color and specifically, I'd like to ask you about the acquisitions that you've made with Penford, for example, where I think they were close to commercializing a few products. I'm just curious, like over the last 2, 3 years, with the acquisitions you've made, has that yet fully or meaningfully impacted any growth in your sort of new customer acquisition or sort of growing the wallet with existing customers? You've obviously gotten cost synergies out of the deals and they've been very attractive from a financial perspective. But I'm just thinking big picture, you bought these -- bunch of assets to expand your portfolio to strengthen existing relationships, and then also hopefully build new ones. So can you give us some color as it relates to these assets in terms of how they're playing through today?

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

Yes, no. You're right, that National Starch and Penford were more on the cost side, but I would say that Penford, which is a couple of years into the acquisition, one of the key strategies was to come with potato starch solutions that are gluten-free and non-GMO. So that has brought us a number of new customers and new opportunities. So we continue to be very excited about that. And then the more recent acquisitions, it is pretty early, but between Kerr and TIC Gums, we really are excited about the opportunity to deliver solutions to the small and medium-sized customers where we see more of the growth coming and a faster to market with some of the new products. And so we become more important to customers like this with our product development capabilities. And so with solutions -- blending solutions for those types of customers, fruits and berries for smoothies, and then the non-GMO sweetener type solutions for all those types of customers really -- we're really well positioned to deliver those solutions. So I think that's what's behind our feeling very good about our specialty growth in a number of the comments that we alluded to here today. So we're on track.

Operator

Our next question will come from the line of Farha Aslam of Stephens.

Farha Aslam - *Stephens Inc., Research Division - MD*

I'm still kind of confused about South America. I'm sorry to keep going back to this region. But in the second half of this year, do you expect earnings to be up versus the second half of last year, given you should have restructuring benefits and a much, much more benign corn environment? Is that how we should think about it?

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

I think that the -- while we have set up for a better run rate on labor savings as well as manufacturing expenses, I think the one thing that's still over our head is how quickly some of the customer recovery of our sales in Argentina will occur. So it's really hard to measure that in July and August in the midst of winter, particularly when you're selling into beverages. So we really need to just be kind of middle-of-the-road and continue to do our job in terms of servicing our customers and see how that plays out really into Q4. But that's -- in prior comments, getting back to the second half and South America is generally the majority of the profits. We have taken actions over the last 18 months to improve our cost position in both Brazil and Argentina. I think we're perfectly set up for some nice leverage if we get some strong customer recovery, and we see any glimpses of economic growth and stronger consumer pull away for our customers' products, then we should be -- have some nice momentum.

Farha Aslam - *Stephens Inc., Research Division - MD*

And then just in Korea, do you manufacture in Korea? I thought that Korea was an import market for HFCS and historically, you serviced Korea out of both the U.S. and Argentina.

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

No, Farha, we've manufactured in Korea for years. But we do import corn because there's no real local corn. But we do manufacture, have 2 wonderful facilities there, serve the local market with both core and specialty and have added capacity on the specialty sweeteners side. So definitely, serve it locally with manufacturing.

Farha Aslam - *Stephens Inc., Research Division - MD*

So your strategy in Korea is that you want to trade up to the higher-margin items, more consistent profits. So you're pulling back on HFCS because you don't want to add additional corn wet milling capacity?

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

Well, we always like to do that because, as you know, the corn wet milling is the most expensive part of the process. So absolutely trading up and redirecting the corn wet milling to more higher value ingredients is always our goal. And what's nice about the Korean market is people want to eat healthy. And so it's a mindset there and well positioned for us to serve these specialty sweeteners in that market. So absolutely.

Farha Aslam - *Stephens Inc., Research Division - MD*

My final question is really about the longer term. I understand that you're right now just entering the contracting season for next year so you can't give us guidance. But Ilene, if you had to think about -- and just go through your regions of where you anticipate the growth drivers to be for next year, could you just highlight those for us?

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

Yes. I mean, I think of it a couple of different ways. So if you think about our organic capabilities, certainly North America, as I mentioned earlier, that we've added capacity in specialty, we see the consumer wanting healthy ingredients in texture and wholesome specialty sweeteners like non-GMO sweeteners. So we're excited about that opportunity. And U.S. GDP is considered to be over 2%. And that's pretty good. As I think about South America, as I mentioned. I also see some GDP growth coming into next year. In fact, Brazil is supposed to be 1.3% next year and Colombia, over 3%.

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

And first time up in 3 years.

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

Yes, exactly. So I think with the GDP growth in South America, our specialty capabilities, and then the cost rightsizing that we've done in Southern Cone, we are excited about that. And then in EMEA, as you know, our business is very much focused on specialty foods in the Europe side. So we see some opportunities there. And then in Pakistan, we're also growing some of the specialties. And then in Asia Pacific, we've also added some capacity to Thailand for specialty growth with the tapioca franchise there and then our new rice acquisition will have some nice solutions. So I think if you look at it all organically, we continue to feel excited about our specialty strategy. And then I'd put on top of that our M&A pipeline where we continue to look at these bolt-on acquisitions and to build on the ones that we completed in the last 12 months, and be able to supply customers with those capabilities next year with our growth scenario, should be very exciting.

Operator

Our next question will come from the line of Adam Samuelson of Goldman Sachs.

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

I want to follow up on Farha, and I guess Ken's question and really thinking about that long-term North American profit growth outlook off the base that we're going to be setting here in 2017. And I didn't hear in the response an expectation or a confidence necessarily that you could grow the core business from here. And I understand the pricing dynamics, we'll see how those shake out as we go through contracting. But do you think that -- do you feel confident that there's still an ability to grow the profit in aggregate if the core business does face incremental pricing pressures from where we are today?

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

Adam, I think if it's North America focused, I'd like to first break out Mexico and talk about the large population, I think longer term, 3 to 5 years out still, nice prospects for GDP growth. Nice prospects for household or personal income growth. And I think when you think about our core business in the multitude of both food, beverage and brewing solutions that we provide, I think there's nice opportunity for growth in the core growth in our specialty business in Mexico. If you bring it back and focus on the U.S. and Canada, I think there's really 2 things that really drive on us and our focus on our margin improvement and within U.S./Canada, we have a large specialty business within U.S./Canada. We focused on expansion of some of our finishing assets and finishing capabilities and continue to have kind of leading-edge technologies in some of our clean label starches. In addition, the opportunity to take our value-added starches and combine them with gums and other blends through what we're learning with our TIC Gums acquisition, that's one nice driver of profit margin expansion in U.S./Canada. And the second, and we've continue to look at this is now work optimization and continuous improvements and using all of our leaning skill set and capability of our great engineers and our great manufacturing team to continue to figure out how we squeeze more out of our assets. And we're going to continue to work on that within U.S./Canada and use that as a means of driving some margin improvement even if we're facing flat -- flattish volume on the U.S./Canada sweetener side.

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

Okay, that's helpful. And then in the quarter, specifically in North America, the margins were up about 200 basis points year-over-year. You had volumes that were lower and price/mix -- organic volumes that were lower and price/mix that was about flat year-on-year. Any way to break out a little more color on drivers of the margin improvement, whether just the loss of some of those Mexico volumes because of the customer issues there, was it mix-positive or any more kind of clarity or granularity on the margin improvement.

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

I think that if you're doing year-over-year, recognizing that the TIC Gums acquisition would be included in the Q2 in the first half of '17, and that should be margin expanding. In addition, what we'll see is we'll still have that specialty growth continuing in really the kind of mid- to high single digits with U.S./Canada, higher within Mexico. And that's going to drive margin expansion.

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

So you're saying specialty is at a mid- to high single digits in a flat volume -- total volume construct? I just want to be clear on that.

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

Yes, sure because we've said that high fructose corn syrup is usually probably down 1% on volume.

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

TO our trading up strategy and using the same assets.

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

Yes.

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

Right but specialty is only 25% or 27% of your revenues, and so that math still wouldn't work if HFCS is only down 1%, unless the rest of the core is down more?

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

Maybe I'm not following your math, Adam, on that one. We could take it off line. But generally, we've advertised HFCS headwinds for the industry to be down 1%, maybe down 2% kind of -- its been a bit confusing with some of the swings towards regular soda versus diet on shelf. The last couple of years, HF 55 has held up kind of quite well. But I think longer term, I would still assume that there is still some regular cola headwinds, which should impact HF 55 volumes over time. I think the other types of sweeteners that we have in our portfolio have been flat to up, and then what we see in terms of net sales from our specialty has been mid to high single digits.

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

Okay, maybe we'll take it off line.

Operator

We have no further questions in queue at this time.

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

Okay. So just before we sign off, I'll reiterate our confidence in our business model, strategy and long-term outlook. We remain keenly focused on value creation and delivering value to shareholders. Also, I'd like to remind everybody about November 14 as our upcoming Analyst Day in Bridgewater, New Jersey. We hope to see you there. So that brings our second quarter 2017 earnings call to a close. Thanks, again, for your time today.

Operator

Ladies and gentlemen, that concludes our conference call. Once again, we'd like to thank you for your participation in today's conference call and thank you for our using our service. Have a wonderful day. You may now disconnect.