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INGR - Q2 2018 Ingredion Inc Earnings Call

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OVERVIEW:

Co. reported 2Q18 reported operating income of $193m, reported EPS of $1.57 and adjusted EPS of $1.66.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Ingredion Second Quarter 2018 Earnings Call. (Operator Instructions) As a reminder, this conference is being recorded. I'd now like to turn the conference over to our host, Heather Kos. Please go ahead.

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

Good morning, good afternoon, and good evening, and welcome to Ingredion's Second Quarter 2018 Earnings Call. Joining me on the call today 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 will 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. Before I discuss our second quarter results, I wanted to provide a brief perspective on our performance relative to our expectations. We are disappointed with our quarter 2 and year-to-date results, and we are taking aggressive actions in response. In particular, our performance in North America has not contributed as we had anticipated, where we were negatively impacted by operational headwinds: first, higher production costs, coupled with operational inefficiencies, resulted from our ongoing efforts to rebalance our starch inventories across our network; second, freight inflation continued to impact our business; and third, we experienced softer-than-expected sweetener volumes, leading to a weaker outlook for the second half of the year. We must be, and we will be, more agile in addressing and navigating these changes impacting our industry and our business. We are currently taking swift actions to improve our cost structure in response to inflationary headwinds, and we are optimizing our network capacity in North America in response to lower U.S./Canada production volumes.

We established a $125 million Cost Smart savings target and formalized the program to deliver saving through cost of sales, including freight and SG&A reductions, by the end of 2021. Savings will commence in the second half of 2018 and savings delivery momentum will increase each year of the program.

Part of this program includes the cessation of wet milling and production of high fructose corn syrup and industrial starches at our Stockton, California, facility by the end of 2018. The conversion of Stockton into a shipping distribution station enables us to remain well positioned to service customers in the Western United States. In addition to our actions to reduce costs, we will also be pursuing necessary pricing actions to mitigate inflationary impacts.

Now moving to the quarter 2 results. Ingredion volumes grew by 3%. The volume growth was driven by both core and specialty sales. Outside of North America, our South America business continued to recover and performed strongly. Asia Pacific continued to be impacted in the quarter by extraordinary tapioca costs, although the impact was less than in the first quarter due to recent pricing actions. EMEA continued to perform well, with operating income flat in comparison to last year. Apart from U.S./Canada, we demonstrated strong volume growth in all regions and Mexico, which we are pleased about. Our specialty ingredients portfolio continued to grow in the quarter. We're pleased with our performance of our functional native clean-label starches and on-trend sweetness solutions. Our project pipeline and customer demand for our specialty ingredients remains robust. In March, we merged the capabilities that existed from our global key account program, our corporate marketing and sustainability functions and regional customer experience initiatives. That combination was made to ensure that we bring all of our value to customers worldwide. Our organization is incredibly energized right now around doing more for customers in a very innovative and efficient way and being easy to do business with.

During the quarter, we continued to deploy our cash for shareholder value creation by investing in our higher-value specialty expansion projects and by buying back 1.25 million shares.

Before moving to our regional overview, I would like to emphasize the importance of our Cost Smart program. In response to inflation and the anticipated inflationary increases that will likely impact our industry next year, we formalized our Cost Smart savings program. This is designed to improve profitability, streamline our global business and further enable specialty growth through go-to-market and innovation capability building. The $125 million Cost Smart target includes: anticipated savings of $75 million in cost of sales, including freight; and $50 million in SG&A by the end of 2021.

Cost Smart cost-of-sales initiatives include establishing global centers of expertise as well as executing manufacturing and supply-chain network optimization. Cost Smart SG&A initiatives include establishing global centers of scale and expanding our zero-based budgeting initiative, globally. As an example, we are further progressing our finance transformation, building on a successful shared service model we established in Tulsa, Oklahoma, late last year, with the opening of a -- in Guadalajara, later this year. Our anticipated savings are expected to benefit all regions and functions.

Anticipated cumulative cost run-rate savings of $2 million to $4 million is expected in 2018, and by 2019, we expect $22 million to $34 million.

Now moving to North America. Second quarter operating income in North America was $150 million, down 17% versus last year. Overall volumes were up 1%, as higher Mexico volumes and specialty volumes were partially offset by lower volumes from U.S./Canada sweetener and industrial starches.

As I mentioned earlier, North America faced 3 headwinds: our production costs were higher than expected due to our rebalancing of starch inventories across our network as well as some operational inefficiencies; second, freight inflation continued to impact our business; and additionally, we experienced softer-than-expected sweetener volumes, leading to a weaker outlook for the second half of the year. In order to balance our capacity with expected future demand, we announced the actions I mentioned earlier at our Stockton facility, from which we expect to save $6 million to $9 million annually. Additionally, we expect further Cost Smart actions to reduce our cost of sales, including freight and SG&A expenses.

In South America, second quarter operating income was $20 million, up $16 million from the year-ago period. Our Brazil and Argentina network optimization and restructurings have positioned us to be more cost competitive and are delivering against the expected benefits. Volumes were up 8% for the quarter. We expect the 2017 actions we've taken will continue to drive operating performance and specialty sales growth.

Although our Brazil operations were faced with a trucker strike during the quarter, we were able to manage through with minimal impact. We continue to monitor the macroeconomic environment in Argentina and Brazil.

Moving to Asia Pacific. The region delivered $27 million of operating income in the quarter, down 10% versus last year. Overall, the volume was up 1% versus prior year and specialty sales were particularly strong in China, Korea and Southeast Asia. Our specialty capacity expansion investments in Korea and China are complete and commissioned and continue to grow our specialty ingredients throughout the region.

As discussed for the past 2 quarters, Thailand's excessive rainfall, starting late last year, impacted both the tapioca harvest and root quality, which significantly increased raw material costs during the first half of the year. Consistent with our business model for tapioca, we are actively working to adjust pricing to offset the rapid cost increases. Pricing actions helped mitigate the impact of tapioca cost in quarter 2 in comparison to the impact felt in quarter 1. We expect higher tapioca cost to continue in the third quarter until the situation improves in the next harvest in the fourth quarter.

Although, we experienced an unprecedented run-up in tapioca cost over the last 9 months, our extensive production and sourcing network in the region has enabled us to ensure continuity of supply to our customers.

Finally, the EMEA region continued to perform well, reporting second quarter operating income of $29 million, flat to last year. Higher specialty and core volumes were offset by unfavorable foreign exchange and higher raw material costs in Pakistan. We anticipate the strong specialties performance in Europe will continue to support operating income growth in the region.

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

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

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

Thank you, Jim. Let me start by covering the highlights of the income statement. Net sales were up for the quarter. Higher volumes and price/mix more than offset unfavorable foreign exchange. Gross profit margin was lower by 160 basis points. Weaker performance in North America as well as higher tapioca costs in Asia Pacific more than offset better performance in South America. Reported and adjusted operating incomes were $193 million and $201 million, respectively. Reported operating income was lower than adjusted operating income by $8 million. The difference was due to $6 million of severance and other expenses associated with our Cost Smart program, while the balance was due to finance transformation. Our reported and adjusted earnings per share were $1.57 and $1.66, respectively. Moving to the net sales bridge. Sales were up 3% versus last year. Volume contributed $46 million, while price/mix contributed $14 million. This was partially offset by unfavorable FX of $21 million, primarily attributable to Argentina, Brazil and Pakistan currency revaluations. As we look more closely by region, you can see unfavorable foreign exchange affected South America and EMEA, but was partially offset by favorable foreign exchange in Asia Pacific and North America. In North America, volume was up 1%. Specialty volumes were up, but this was offset by U.S./Canada sweetener and industrial starch volumes. Price/mix in North America was down, given higher freight costs. In South America, volume was up 8%, led by sweetener sales in Argentina given the prior year weak lap, as well as growth in the Andean region. Price/mix was up, driven by the pass-through of unfavorable foreign exchange in Argentina and Brazil as well as higher raw material costs.

EMEA had strong volume growth, driven by specialties in Europe and stronger demand in Pakistan. For the quarter, reported and adjusted operating income decreased $17 million and $19 million, respectively. North America operating income decreased $30 million due to higher production costs, driven by continued starch inventory rebalancing, lower U.S./Canada sweetener and industrial starch volumes and higher freight inflation.

South America operating income was up $16 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 $3 million, driven by higher tapioca costs. As we stated last quarter, we expect price recovery to lag for another quarter.

EMEA was flat. Specialty and core volume growth was offset by 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 global process optimization and efficiency via our Cost Smart program. We'll wrap up the discussion of the quarter with earnings per share. On the left side of the page, you see the reconciliation from reported to adjusted. On the right side, operationally, we saw a decrease of $0.19 per share, primarily driven by a margin decline of $0.32 per share. North America and Asia Pacific declines more than offset margin improvement in South America. The margin decline was partially offset by increased volume of $0.13 a share. Unfavorable foreign exchange and other income were offsets of $0.01 apiece. Moving to our nonoperational items, we saw a decrease of $0.04 per share for the quarter, largely driven by higher financing costs and a higher tax rate. Financing cost were $0.05 per share decrease, driven by -- largely by unfavorable foreign exchange. Adjusted taxes were $0.01 per share higher, primarily driven by the devaluation of the Mexican peso at quarter-end, partially offset by U.S. tax reform. Noncontrolling interests and shares outstanding each contributed a benefit of $0.01 a share apiece. Let me move to year-to-date financials. Net sales were up 2% year-to-date. Gross profit was lower by $10 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 $390 million and $401 million, respectively. Reported operating income was lower than adjusted operating income by $11 million. The difference is due to severance and other costs associated with our Cost Smart program of $6 million, restructuring costs related to our finance transformation of $4 million and Brazil leaf extraction of $1 million. Our reported and adjusted earnings per share were $3.47 and $3.60, respectively. Moving to the net sales bridge. Our year-to-date net sales were up 2% versus last year. Volume contributed $64 million, while price/mix contributed $6 million. This was partially offset by unfavorable FX of $15 million, again, attributable to Argentina, Brazil and Pakistan.

As we look more closely by region, you can see unfavorable foreign exchange affected South America, predominantly driven by Argentine peso and Brazil real. Volumes were up in all 4 regions. In North America, volume was up, driven by Mexico and specialty ingredients, offset by lower U.S./Canada sweetener and industrial starch volumes.

In total, price/mix was flat. In North America, price/mix was down, given higher freight costs but higher in South America for foreign exchange and raw material cost pass-throughs. Year-to-date, reported and adjusted operating income decreased $13 million and $29 million, respectively. North America operating income decreased $45 million due to higher production costs, driven by lower U.S./Canada sweetener and industrial volumes, higher freight inflation and some commodity pricing pressures. South America operating income was up $27 million, driven by volume growth and our more competitive cost structure. In Brazil, network optimization, and in Argentina, our new labor agreements and organizational restructuring contributed to cost improvements. Asia Pacific was down $10 million, driven by higher tapioca costs. EMEA was up $3 million, with specialty and core volume growth more than offsetting higher raw material costs in Pakistan. Corporate costs were higher by $4 million, given the same reasons mentioned previously.

Moving to earnings per share. Operationally, we saw a decrease of $0.29 per share, driven by a margin decline of $0.49 per share. North America and Asia Pacific declines more than offset margin improvement in South America. The margin decline was partially offset by increased volume of $0.19 a share and other income of $0.01 a share. Moving to nonoperational items, we saw an increase of $0.12 per share for the quarter, largely driven by a lower tax rate. Adjusted taxes were $0.11 per share, really driven by U.S. tax reform.

Additionally, noncontrolling interests and shares outstanding each contributed a benefit of $0.01 apiece, while other nonoperating income was a negative $0.01 a share decrease.

Moving to cash flow. Cash provided by operations for the first half of the year was $352 million. Capital expenditures of $160 million were up $16 million year-over-year, driven by specialty investments. Additionally, as Jim mentioned earlier, we bought back 1.25 million shares for $141 million.

Turning to our guidance. As mentioned in our preannouncement release, we anticipate 2018 adjusted earnings per share in the range of $7.50 to $7.80. This reflects a lower operating income outlook for North America and 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 the impact of foreign exchange will be slightly negative to neutral. As we've explained in the past, given our business model for most regions, foreign exchange is effectively a pass-through. We expect operating expenses to be up year-over-year as we invest in global business process optimization and efficiency to drive long-term structural cost reduction through our Cost Smart program. We expect financing costs for the year to be in the range of $75 million to $78 million due to higher interest rates on our floating-rate debt, refinanced maturities and foreign exchange losses.

Our adjusted effective annual tax rate is expected to be 26.5% to 28%. This reflects a benefit of approximately 2% to our weighted average effective tax rate from 2017, driven by U.S. tax reform. We expect total diluted weighted average shares outstanding to be in the range of 72.7 million to 73.2 million for the year. In North America, we expect net sales and volumes to be flat. For the full year, we expect operating income to be below 2017. In Mexico, we expect volumes to be up. In U.S./Canada, we expect higher production cost driven by continued starch inventories rebalancing, lower sweetener and industrial starch volumes and higher freight inflation versus the prior year. South American net sales are expected to be up versus prior year. Volume recovery and favorable price/mix are expected to offset foreign exchange headwinds, and operating income is expected to be up. In addition, we anticipate positive economic growth in Brazil. We remain watchful of the economic reforms and hyperinflation 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 flat to down given tapioca cost headwinds, which we expect to continue until the fourth quarter harvest. EMEA should continue to deliver net sales and operating income growth. We expect improved core and specialty volume growth. We are monitoring the changing political and economic landscape in Pakistan.

Excluding onetime cash benefits from tax receipts, we expect cash from operations in 2018 to be in the range of $800 million to $850 million. We expect to invest between $330 million and $360 million in capital expenditures around the world to support growth as well as cost and process improvements. Importantly, we remain committed to returning capital to shareholders, as we demonstrated in Q2 with the repurchase of 1.25 million shares. That brings my comments to a close. Now back to Jim Zallie.

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

Before we go to the Q&A session, I would like to conclude with the following comments after having been in my role for a little more than 6 months. We are operating with a strong sense of urgency to recover from the first half earnings setback and the impact that will have this year. Our actions at all levels of our company consist of a necessary focus on cost reduction, operational excellence and pricing actions.

Importantly, we are also driving commercial excellence and innovation, with an intense focus on our customers. We will continue to use our strong balance sheet to invest in specialties growth opportunities, including specialties M&A. We remain committed to returning cash to shareholders. All of this is consistent with our commitment to deliver our long-term earnings growth algorithm. And now, we're glad to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question is going to come from the line of Brett Hundley.

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

My questions really center on North America, and I wanted to ask a question on the U.S. So historically or, I guess, since 2010, domestic HFCS disappearance has been declining by almost 2% a year. And then, inside of that statistic, USDA data shows that domestic HF 55 has been roughly flat. However, over the past couple of years, it looks like 55 here in the States has been sliding more, maybe by about 60 bps a year. And I'm really wondering if that's going to accelerate going forward. It seems like large beverage companies here, if you read the transcripts of KO or Pepsi, it looks like they are really starting to gain momentum behind a push for 0-calorie options and things like that, while really focusing on healthier parts of their portfolio. So, I guess I have 2 questions surrounding this. Do you think that 55 demand is sliding even more now as a result, number one? And then number 2, what does that mean for the specialty sweetener market? And when I ask that question, not only am I asking about what it means for the specialty sweetener market, but also your participation in that potential growth of specialty sweeteners.

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

Yes, let me take that. So first of all, the data that you cited in relationship to HF 55, our data would show that over the last 10 years, that 55 has declined probably in the same range of the 2% as you had for the overall consolidated. But nonetheless, putting that aside, let me start by putting the sweetener market fundamentals into context. The total sweeteners volume for both industrial or nonfood and food usages over the last number of years is relatively flat. There definitely has been growth in industrial usage or nonfood, such as for renewable chemicals and/or as a fermentation substrate. However, HFCS has continued to decline. We produce sweeteners for primarily food-grade applications, thus each player in the industry is impacted differently by their mix of sales to nonfood versus food and uses across different customer bases and geographies. So we believe that the fundamentals, with us taking action to close production at Stockton, does support solid fundamentals for HFCS for us, post our actions, and for the marketplace. Hopefully, that answers your question.

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

Yes, I appreciate that. I'm going to follow-up offline, actually. And I just have 2 other relatively quick ones. So first of all, Jim Gray, do you guys have a 10b5 trading plan in place?

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

Well, currently, we're in a quiet period up and through this call.

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

Okay. And lastly, just on the evaluation of M&A, Jim Zallie, I think you were talking recently at a conference or with a media outlet, I can't remember. But you were talking about evaluating small and large M&A for your company. And I wanted to ask you about the larger transactions right now and how you might evaluate those transactions or even pay for them in this marketplace, when the cost to consolidate larger companies is so elevated right now, combined with a retreat in your share price more recently. I'm just curious how you think about M&A going forward and if that maybe skews you down towards smaller acquisitions over the near term.

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

Yes, you're referring to an interview that I did just last week with The World of Food Ingredients and Food Ingredients First, where I received that question. And what I said is that we remain very focused on acquisitions that were going to be primarily, almost exclusively, based on enhancing our specialties portfolio and that are aligned with value propositions that are such as wholesome clean label, health and nutrition, textural innovation. Those value propositions would be consistent with our M&A and specialties M&A growth strategy.

We're looking at, obviously, smaller tuck-in bolt-ons, which would be $300 million to $500 million range, as well as always keeping our options open to do something that could be transformational, should it arise. The beauty of our business is that we generate solid cash and have a very strong balance sheet that would afford us those options. So we're always looking for specialties M&A that is going to create shareholder value for the long term. So we're very committed to the target of $2 billion in specialties growth by 2022, 32% to 35% of our portfolio, and M&A as an enabler to not only hit that target but to exceed it.

Operator

The next question is going to come from the line of Akshay Jagdale.

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

Akshay?

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

Can you hear me?

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

Yes, we can.

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

Sorry, I just jumped from another call. I don't know if you addressed this already on your opening remarks, but can you just talk about what you think the impact of your capacity rationalization plans will have or is having on pricing discussions? I know in the commentary in your press release, you mentioned you're going to also take some pricing actions. So -- but you have contracting season, right? That's probably not yet started. But how do you think the capacity rationalization will impact those conversations?

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

Yes, the comments that I made earlier relating pricing actions are really in response to inflationary headwinds that we're experiencing this year. We talked about freight in quarter 1, continuing into quarter 2, as well as just other inflationary pressures related to, say, chemicals and packaging, et cetera. So those are necessary pricing actions that we are taking. And I really can't forward look as to what the outlook is yet for 2019. It still is very early, as you referenced. And it would be premature on my part to make any comments in that regard.

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

Just as a follow-up. My question is more about, do you think that your rationalization brings into balance the supply and demand for the industry, given the challenges we've seen this summer, as it relates to corn syrup or HFCS-55 demand at least?

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

Yes, let me let Jim Gray take a shot at that. Jim?

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

Yes, Akshay, I mean, it's hard for us to comment on what the industry is doing. We know for ourselves that the cessation of wet milling at Stockton and halting our production of high fructose and industrial starches there allows us to rebalance into our plants in the United States, Canada and Mexico and that will improve our utilization, and we think that gives us several years of headroom.

Operator

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

Unidentified Analyst

This is [Tim] on for Farha. I just had a couple of questions surrounding North America. How are the starch inventories tracking against company expectations? And how is the freight inflation progressing versus company expectations? And have service levels improved since Q1?

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

Yes, so what I would say is that our starch network rebalancing efforts are well underway and good progress is being made. And I just want to take a moment to put this issue into context. We entered the year with an active plan to optimize starch production across different starch manufacturing facilities to support our global starch network. And this is -- it's something we do routinely, because starch transports more easily, it's in a dry-powder form, and we have 3 or 4 facilities that we flex across our network, and we're continuously looking to optimize, based on how our customers change through contracting each year and where it's most optimal to get arbitrage. But when you do that, it's a complex undertaking. And that's under normal circumstances. As we indicated in quarter 1, we experienced uneven demand early in the year, which complicated an already complex project. And then, it was really further exacerbated by the trucking shortage coming out of the blocks in January. We also didn't execute, to be quite frank, as we typically do, and we're actively working to remedy this, and we anticipate steady improvement in rebalancing our starch network with year-on-year improvement. And then as it relates to freight, as we've indicated previously, we've already begun taking steps to mitigate the impacts we are experiencing, and we believe, for example, 2019 dry van impact should be less than in 2018, and we continue to monitor just the overall general inflationary market for freight. But both are progressing, I would say, well as we move into the second half of the year, based on all the actions that we are taking.

Unidentified Analyst

Okay, great. And just one follow-up question. What's driving the higher raw material costs in Pakistan? And how long does the company expect this issue will persist?

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

Jim?

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

I mean, the higher raw material is corn and that's due to the size of their winter crop, which was smaller than expected, and we just lean more towards the second crop in the year.

Operator

Our next question is going to come from the line of David Driscoll.

Cornell R. Burnette - *Citigroup Inc, Research Division - VP and Analyst*

This is Cornell Burnette in (inaudible) for David. Just wanted to start off and ask you, pardon me if I missed this on the beginning of the call because I got on a little late, but what was the percentage decline in the core North American sweeteners in 2Q and then, year-to-date?

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

Yes, Cornell. We don't really talk about any volume declines within a country, and we talk about our sales variants at a region level. And that's the mix that I went through on the slides and then the presentation.

Cornell R. Burnette - *Citigroup Inc, Research Division - VP and Analyst*

Well, can you at least give us maybe just some sense of kind of how to scale, kind of, what's the exposure in North America, the core sweeteners that go into beverages and food, kind of, given some of the headwinds that we've seen from those industries?

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

Yes, I think maybe our comments on the change in our outlook, particularly driven within U.S./Canada, is really more -- some of what we experienced in Q2, but really more of what we expect to experience in the second half. Just as we read and you read what we think the actions are taking place, particularly in the beverage market, we're just sort of incorporating that into some of our outlook for the second half.

Cornell R. Burnette - *Citigroup Inc, Research Division - VP and Analyst*

Got you. And then to go on a little bit further, maybe a little bit further out, can you just talk about -- again, in light of some of the recent actions, you've taken Stockton down and so forth, kind of, what's the ability of, kind of, the North American business to grow, perhaps once we lap some of these issues in freight and get into a new year of new contracting, given some of the things that you've been doing on the production side?

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

Yes, Cornell, it's Jim Zallie. So with the actions we're taking with the Stockton repurposing, we believe, the fundamentals in the sweetener market in North America remain solid. The actions we're taking to rebalance our starch network will provide headroom for growth into next year. What's unknown for everyone in the industry right now is the impacts of inflation, the unintended consequences of trade disputes, international tariffs and the pricing outlook. We've historically demonstrated that we can navigate these kind of market conditions, given the strength of our business model. And additionally, prior to assuming our roles, both Jim and I led the North America business to its record level of profitability last year. We both deeply understand the market dynamics and the customer fundamentals. And thus, we feel, in answer to your question, that we have levers at our disposal to maintain and grow our profit pool.

Cornell R. Burnette - *Citigroup Inc, Research Division - VP and Analyst*

Okay, very good. And then, I guess, the last one for me is just kind of on the Cost Smart savings program. Should we think about all of those savings in theory kind of dropping to the bottom line? Or there's kind of investments that you have targeted for a portion of those growth savings numbers that you've cited?

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

Thanks, Cornell. Let me talk about how we're going to address Cost Smart going forward. We purposely describe our Cost Smart savings as it relates to cost of sales in freight, which will drive our gross margin, and separately SG&A, which drives, what we call, our OpEx. But we expect Cost Smart to provide a positive impact on gross margins and on our operating and expense ratio, which will be defined as SG&A as a percent of our net sales. When we talk about the rate of the -- the run rate savings of $2 million to $4 million starting in late 2018, this grows to $22 million to $34 million cumulatively in 2019, and then building to $125 million by year-end 2021, before inflationary effects. So when you think about inflation, we would expect that our net inflation for cost of sales in freight and SG&A will really be less than our rate of revenue growth. And so the net is you're going to have inflation, offset it with Cost Smart savings. But that rate of change from year-to-year will be less than our rate of revenue growth. Thus, we expect an improvement in gross margin and a reduction in our OpEx ratio over the program's life. And then furthermore, we'll come back and we'll update against Cost Smart at least twice a year.

Operator

Next we go to the line of Ken Zaslow.

Omar J. Mejias - *BMO Capital Markets Equity Research - Associate*

This is actually Omar filling in for Ken. Just a quick question on, sort of, your growth algorithm. Do you guys still expect to hit the long-term growth targets that you guys initially laid out at your Analyst Day? Or is 2018 a reset on that base?

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

We are still committed to hitting the long-term earnings growth algorithm that was cited in our opening comments. And that was, I think, further supported by my answer to Cornell's question, primarily related to North America, which is obviously a big driver in our view on our ability to pull some levers in North America.

Omar J. Mejias - *BMO Capital Markets Equity Research - Associate*

That's helpful. And with regards to the inflationary cost environment, what percentage for you -- of your portfolio is impacted by this just recent inflationary cost environment? Basically said differently, are you guys -- what part of the portfolio is insulated from the recent headwinds? Just from a high level, if you could talk to just the way the contracts -- just from -- no specifics, but just high level from a contract base or from a pricing power standpoint.

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

Do you want to answer that, Jim?

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

Yes, I'm trying to maybe -- to clarify your question. In some countries, there's a method of contracting, allows for some direct pass-through of costs and -- for example, in the United States/Canada, there is some pass-through of changes in corn, where our customers are sophisticated enough and willing to accept that risk and believe they can manage it better on their own as well as is -- we have some freight cost pass-throughs, okay? In other countries, the model is such that if there's changes in either our underlying raw material or our manufacturing inputs, we price on a fairly close frequency. We may reprice 4 weeks, we may reprice in 6- to 8-week increments. So generally, we're trying to make sure that we capture any changes in the underlying corn or tapioca or raw material. We're also trying to capture changes in FX. If other manufacturing inputs tend to inflate, our business model really allows us to absorb that and try and actually mitigate that as we look at pricing pass-throughs.

Operator

(Operator Instructions) And next, we'll go to the line of Adam Samuelson.

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

Can you hear me?

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

Yes.

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

I apologize, jumping between earnings calls. I was just hoping for a little bit more color on the North American margins this quarter and just thinking about the earnings bridge year-over-year and thinking about freight inflation, some of the headwinds on the starch utilization side, some of the sweetener volume pressures that you cited. Is there any way to quantify, kind of, what each of those impacts were? And then, I have a follow-up question on the back half of the year.

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

Yes, let me take a shot at that and then Jim can add color commentary. So this would be kind of a reset quarter 2 update from what we said in quarter 1. But at the end of last year, we ended with North America operating income at $654 million. If one anticipated low to mid-single digit growth on top of that, you might have expected around $680 million of operating income in 2018. In quarter 1, we said we had $17 million of higher freight costs, $20 million of incremental production costs related to rebalancing our starch inventories and $10 million of commodity pricing pressures. In quarter 2, these full year impacts remain as expected. However, in quarter 2, our sweetener volumes were unexpectedly lower and production costs higher, given weaker customer demand and outlook. The full year sweetener impact against the most recent earnings forecast is expected to be an additional $20 million. Also in our latest guidance, we've included an additional $5 million to $10 million of expense for operational inefficiencies across both starch and sweetener, which is a source of focus and opportunity, as we see it, as we move into the second half and into 2019. So hopefully, that's clear from a standpoint of what's new and what's changed, quarter 2 versus quarter 1.

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

That's very helpful. And then just following up, as I think about the back half of the year, there is an expectation that the earnings growth improves from where we are, and I get that the fourth quarter comp gets considerably easier, given some of the issues that did happen in the fourth quarter of last year. But just from a year-on-year perspective, at the corporate level, I mean, how do I think about the back half performance versus the first half? Is it just a better balance of utilization in North America, that you don't have some of those unabsorbed overhead? Or help me think about some of the mix there.

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

Yes, Adam, this is Jim Gray. Part of it is the lap of what we're facing, both in North America as well as in Asia Pacific. So to remind you, the tapioca shortfall really started surfacing in September/October of last year, and that did impact us in Q4. Within North America, we believe that Mexico continues to perform well. And then as we look at U.S./Canada, the efforts that we have begun here in the beginning of the year, as Jim has talked previously, to what we're -- actions we're taking with regards to freight as well as how we've worked through our starch inventory rebalance, we think some of those effects mitigate the inflationary pressures and the additional production costs that we've seen and allow us to move into Q3, Q4, I think, with a kind of a more stable view of margins within North America.

Operator

And at this time, there are no further questions in the queue.

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

Okay. All right, very good. All right, well, I'd like to thank everyone for your time today. And that will conclude the call.

Operator

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