Ingredion, Inc. Goldman Sachs Global Staples Forum May 18, 2021

Adam Samuelson:

All right, great, thank you (silence). All right, great. Well, thank you, everybody, and good afternoon. My name is Adam Samuelson. I'm the agribusiness and packaging analyst here at Goldman. Happy to continue our Goldman Sachs Staples Forum with Ingredion, one of the largest producers of corn base and specialty ingredients in the United States and around the world. We have their CFO, Jim Gray, here today. Jim, welcome.

Jim Gray:

Hi, Adam.

Adam Samuelson:

We're excited to have you. We're going to jump into a Q&A and fireside chat in one second, but I want to remind the audience that there is a box in your webcast window to type in questions. We love getting them in from the audience. Please do send them in. They'll come to me, and we'll be getting to those through our discussion, so any questions from the Global audience, please do send it in. But first, Jim, maybe let's just start... Let's level set. We'll maybe talk about the current market environment on the demand side. Obviously, now starting to lap pantry stocking with COVID last year, which had some positives and negatives in different parts of your business. Can we maybe take a tour around the world and think about volumes and different regions and different product categories?

Jim Gray:

Yeah, sure. Happy to. As you mentioned, lapping some of the pantry stocking, but also lapping some of the food service decline and due to restrictions, whether or not consumers around the world were hitting their local pubs or their favorite food joints and having a soda. As I look at the year and the lap into Q1 and even April activity, if you start with the US, you've largely seen food service traffic come back. And I would actually say it's lapping 2019 levels and even higher here in the last couple of months. It's a combination of stimulus checks, a lot more confidence with people being vaccinated, and I think just businesses opening up in general.

Jim Gray:

So that'll benefit us in what I would call our syrups and our sweetener business. That was the business that probably had the biggest volume impact from last year's food service channel pull back. We'll benefit from that, and that volume is benefiting us as we look into Q2 and the rest of the year. I would characterize really two markets. So you have a developed market like the United States, which has a pretty high penetration of vaccinations and is moving along. And then you have other countries, some of which are in our portfolio and we have significant businesses there, where the vaccination rates are not as high.

Jim Gray:

And If you look at Mexico or Brazil or Pakistan what you have is still a return to consumer mobility, some of it driven by a necessity to work, and just being able to bring an income into the family, some of it driven by just being too cooped up, particularly in the Southern hemisphere, over summer. And you just saw the activity, just people just had to get out and enjoy the weather and move around.

Jim Gray:

What that's done is that even though a pandemic case rates are somewhat high in some of these countries, the demand for our ingredients in to our customers is not nearly as down as much as we may have experienced in March, April, May of last year. Probably maybe 10% to 20% of the impact of that decline that we experienced last year. So you really have either people getting used to the pandemic, finding a way to manage through, or by necessity of either school or work, returning to some of the consumer mobility patterns that we witnessed, say, in 2019. So that'll be a tale that I think will help the business throughout 2021 in some of these emerging countries and these developing economies. And we'll see that probably fully play out by the end of the year or maybe into 2022.

Adam Samuelson:

Okay. That's really helpful. And maybe just to clarify something you mentioned earlier, just on the sweeteners and the syrup side, is that specifically beverage and food grade high-fructose in the US where you're seeing those volumes back at 2019 levels?

Jim Gray:

Yeah, yeah. That's primarily VHF. Yeah. And then I also say in Mexico we have a brewing adjunct. In Brazil, we do a brewing adjunct, which is into beverages. And yet I've seen some of those still recovering a bit, but pretty close, much more low single digits, mid single digits type of volume, and just continuing to climb back.

Adam Samuelson:

All right. That's really helpful. And then maybe anything notable in the differentiation between some of your specialty products and some of your more base commodity products? Are they all kind of rising tide lifts all boats?

Jim Gray:

No. I think as we noted, as we finished 2020, our specialty, particularly our texturants actually did quite well. We had probably one back-up in May where there was a bit of a grocery or take home readjustment to pantry stocking and SKU simplification, and trying to make sure that the right main pack and main variety of one of our customer's products was really on shelf, just because everything was so constrained. Grocery labor was constrained. Packaging availability was constrained into the CPG companies.

Jim Gray:

But as you came out of that and some of the restocking occurred and was evident on Walmart and Costco and grocery store shelves, the ingredients demand for some of our texturants and our specialty food starches really did quite well. And you saw things like ready-to-eat meals really did well, I think, in the second half of 2020. And so so our lap into 2021 is similar to what we would continue to see. So I don't see extraordinary bounce back and specialty ingredients because 2020 was actually pretty good from a volume perspective, overall.

Adam Samuelson:

All right. That's really helpful. So maybe from the demand side on the near term, let's talk about some of the cost dynamics. Inflation has been a hot-button topic across the market and across staples and ingredient sectors through first quarter earnings. For you, there's a couple of key buckets. Let's start with corn, which is going to be the biggest one, and then maybe let level set for where we are in terms of our corn procurement for the year and the co-products side of that, how that is a positive or negative as we watch corn prices over the balance of the year.

Jim Gray:

Yes, I think it's really helpful to understand, if I started in the fall of 2020 in our contracting season, corn was trading just below $4 a bushel and then really mid December, it just started heading up, at least with regard to a US CBOT market. And we've seen the ... Depending upon which future you choose to look at, it's touched definitely into the $6 range and pushing some of the futures, broken $7. And they've come back a bit recently, but nonetheless, you're talking at least a $2 change upward in the cost of corn. And then as you asked and mentioned, there's a couple of co-products, three co-products that we sell, that offset that cost of that corn. And those co-products have also increased in value.

Jim Gray:

I wouldn't say that they've offset the total increase in the gross cost of corn, but they've offset a nice chunk of it. So net-net, I think we're still probably looking at maybe a $1.50-ish-a-bushel increase in the cost of corn, between where we started the year and now. Now that said, we have a hedging policy within the US and Canada that we follow. And so largely at this stage of the year, we're covered on all of our gross corn costs or gross corn needs as we finish the year. So what's really just dependent is does the corn cost stay elevated and do the co-product values remain elevated at this level? I would say we anticipate a little bit of softness in those co-product values and what we're thinking about the back half of the year.

Adam Samuelson:

Okay. Maybe just closing the loop on corn, first, more recently been very dry in Brazil, which is an important region for you. Anything to note in terms of corn availability that you're looking at with some of the ... Seems like the crop expectations there are getting smaller as it doesn't rain. And so just anything to note there?

Jim Gray:

Yeah. We're not seeing anything necessarily in availability, mostly because just the absolute size of the corn crop is so big relative to our production needs, but obviously we're wrestling with the higher cost of the corn domestically. And what you've seen in our Q1 results in Brazil is that some of the contracting method and how we've managed the co-products has been a benefit in terms of stronger price mix, particularly Brazil is really the one that has driven the South America performance in Q1. And so in some ways that, unlike or maybe in contrast to, the United States' form of contracting within Brazil, and also partially within Columbia, that the [inaudible] for the corn, it can be a benefit. We've also worked a lot on our pricing down there. And so that's also been a driver. But I would say that there is a little bit of a tailwind in terms of just where the cost of the corn is.

Adam Samuelson:

Okay. All right. No, that's really helpful. And then how about non-corn items, which for you, I mean, freight, labor, chemicals, just help us think, energy, just think about how some of those other items, which have also been inflationary, how those are impacted in the business and what you're seeing.

Jim Gray:

Yeah, well, I think that freight is one of the biggest components of our costs. A couple of years ago in our reporting, we moved freight into cost of sales. And as such, freight for us is really an issue between products moving from AsiaPac to North America and Europe and back to China. And then within the US or within Canada/Mexico, rail, and trucking are probably our bigger components of our cost. The way that we approach contracting with customers is both a price for a product of our finished good and a price for the freight. And so really going into this year, we already had an idea of what dry van or what freight rates to the customer might be. And we set those expectations early. We'll see really how the second half plays out. I mean, obviously there's quite a bit of supply chain constraint happening right now, but you see it loosening up. I think with ocean freight, more containers are being made available, which will help movement of product in ports, unloading and moving around, and in dry van or trucking is usually a model that actually, as rates go up, you get more drivers coming in and then you get more availability and then rates soften. So we're just watching freight.

Jim Gray:

I think with regard to some of the other key inputs, Adam, that are probably not as clearly passed through to customers that hit our manufacturing costs, the energy complex around the world, we largely hedge natural gas. And natural gas rates have been somewhat favorable. As we look, I mean, we had a little up and down in Q1 given the cold weather. But largely that's been something that's been quite predictable. And so we're really, then, just watching some of our less expensive inputs, both whether it's plastic supply, plastic, or plastic wrap, pallets and/or our chems. And those seem to be relatively in control right now.

Adam Samuelson:

Okay. All right. That's really helpful. So if we want to maybe to close the loop on the cost side, and it's a question that we've gotten a lot from investors is thinking about ... It's early, but how do we think about the implications for '22? It sounds, as you just described, the demand side, especially in North America seems better, which is encouraging. The cost side is still ... But if we think about where corn is today, or probably going to be in the second half of 2021 relative to when contracting happened last year, it's substantially higher. How do we think about that balance and the pricing bogey that you have to wrap your head around?

Jim Gray:

Yeah, well, I think first an answer globally is US dollar-based corn prices have escalated in non US/Canada markets. That pricing is getting translated into a domestic corn cost and our teams are working to pass through that change and that cost, just as if we had FX exposure in Brazil or someplace else in the world where we're working to do that. And sometimes we have a lag on that, but generally we've been pretty tight on that pricing.

Jim Gray:

So really the question that I think is really around the US/Canada portion of our business that's part of North America. And just to reflect, and maybe remind some of the folks tuned in here within that US/Canada business, a little bit more than half of our business really passes through that change in the cost of corn. And it's usually to our largest, more sophisticated customers have those types of contracts. And so they're actually witnessing cost increases today, unless they've placed a lot of hedges earlier in the year, which some have. But they are seeing that higher cost of corn passing through right now, as we reprice monthly.

Jim Gray:

It's really the other half of the customer base that's in US/Canada that probably gets some attention from us. And it's really a lot of medium and smaller customers, thousands. And so for them, they're enjoying a very beneficial contract timing this year. And so as we go into the fall contracting, I firmly believe that the cost increase of the corn, however it may net out, by the time we get the September/October will be something that's reflected in pricing, as necessary. The corn is just too much of a variable cost for all the suppliers in the industry.

Adam Samuelson:

Okay. All right. That's really helpful. So maybe now let's take a step back and think about it longer term. And clearly the growth algorithm for the company has been very much predicated on specialty ingredients. Maybe first, can we just remind investors how you actually define specialty ingredients? What is in that bucket? What's not?

Jim Gray:

Yeah, sure. Internally we defined, I think, eight criteria. Two are kind of similar in how we look at a specialty. But first of all, the ingredient has to have functionality, which then is also reflected in the value for the customer. It has to be in a growth segment or where there's takeaway from the customer that's growing. And then we also look at what's the implied gross margin from the product or products that are in that segment and are those usually two X what we're seeing in maybe our more commodity-like syrups business. And then we also look at is there a patent protection and is there differentiation that we can achieve around that particular ingredient? So those are the criteria, but really they help establish a good competitive mode and they're highly valued by the customer as reflected in usually the price point.

Adam Samuelson:

So can we just dig into a few of those? So on the margin differential, is that percent gross margin, or is that gross margin per pound or per bushel? Just because sometimes the increase in specialty mix is not always clear in the consolidated financials. And so that's what I'm trying to make sure people are getting

Jim Gray:

Yeah. Yeah. It's really two factors. So one, the higher percent gross margin is usually reflected in a specialty ingredient. But then also what accelerates that profit impact to our bottom line is that the average price per ton for specialty ingredients is ... Right now I would argue that it's probably four to five times the average price per ton for more of our core ingredient, syrup. So you get both a dollar value as well as a profit per ton benefit from focusing on growing specialty.

Adam Samuelson:

Okay. And then the point on the IP protection and unique formulation, how much of that ... I mean, help us think about some of the intellectual property that defines that competitive mode and the pricing power inherent in that.

Jim Gray:

Yeah, absolutely. I mean, there's a lot of intangible value, I think, as you focus on the specialty business. One that's very evident is, well, what's your IP portfolio and how much of it is actually protected ingredients are protected process? And I'd probably say that's probably 6% to 7% of our net sales, total net sales, and so a higher proportion of our specialty, that we still have patent life left and/or exclusive rights to the technology and the manufacturing. But beyond that, I would say that there's a confluence of two or three things that have to happen in order to be able to take a plant-based material and make it a fairly unique, highly functional ingredient, and it's really three.

Jim Gray:

So one, you got to be able to formulate into the recipe for the customer. And so that's food scientists and that's technologists. Two, you have to be able to convert that plant-based material in a high-yield way, in a consistent way that's food quality and meets regulatory across the globe. And three, you have to identify the plant-based material that's coming in. If it has requirements like non-GMO, or it's going to be from a certain region of the country or it's a certain varietal, So the type of yellow pea or the type of corn that starts the process so we have plant-based research around the type of species that we're actually cultivating and growing.

Jim Gray:

So those three things, if you bring those together in your value chain, you can actually create a nice arbitrage between the cost of the plant and the cost of the raw material versus this 24-7, 365 ingredient that consumer packaged goods really want and need that fits into their supply chain.

Adam Samuelson:

Okay. And so let's think about some of the specific applications that Ingredion is particularly focused, on between texturants and some specialty sweeteners and plant proteins, which I think would reasonably encompass most of it. Maybe any kind of talk about the key growth drivers as you see it, maybe where you're most excited and where the points of differentiation are our clearest?

Jim Gray:

Sure. Texturants is one where it's probably a little vague in the description. So to the extent I think about a flower, and then I go to a purer form of that flower called a starch or a functional starch. And in what it does is starches are basically hydrocolloids, and so they allow flavors and they allow other oils and things to cling to that starch molecule, and then how that starch molecule separates from its other starch molecules, depending upon temperature and depending upon composition, that forms what you and I think of as the composition of something that we eat.

Jim Gray:

So you can think like a jello pudding. You put it in a bowl, it's this dry powder. You add milk and all of a sudden it's creamy and it has this certain density to it. And it has a certain mouthfeel when we're consuming that product, so that texture is very much part of taste. And so what our team has done on texturants is whether it's with a starch, like a potato starch, or a tapioca starch, or a rice starch, or it's a natural gum, like gum arabica, we really have thought about what's the customer's need in terms of what's the recipe. How does the final food product supposed to look? How's it going to be manufactured? And how's it going to be prepped by the consumer prior to eating it? So that experience with the consumer offers that texture that I think is really valuable. So it's high functionality. It's also lower cost in the recipe. So whether you're replacing an oil or maybe you're replacing a milk fat, or you're replacing an animal protein, the starch with its functionality has a much lower cost in recipe for the customer. So that's why we see, I think, continued growth around the world as we think about our texturant portfolio, and particularly as you go into to developing in emerging countries. Like China, we see just a wide open path for modified starches that are plant-based. So that's texturants. You want to talk about sugar reduction maybe?

Adam Samuelson:

Sure.

Jim Gray:

Okay. I think obviously one of the mega trends that's facing us that I think many governments, many public health agencies are worried about is just caloric, how many calories and how many added sugars. And so while we sell those products, we also have visibility into what's required to reformulate sweetness in a recipe to actually reduce the calories. So how do you mimic that mouthfeel? How do you mimic what the consumer brand is really looking for? And so we purchased a company called PureCircle, which was the market leader in nature-based stevia products. And as we moved towards high intensity sugar reduction sweeteners, we're also thinking about what's the compliment to that to make sure that you still have that composition and the mouthfeel. So whether that's allulose or various like isomaltose or other types of build back where you can basically take out the syrup and replace it and still have the composition but have basically lower calories.

Jim Gray:

So sweetness is a system design approach. And so happy to have even more tools, I think, in our ingredient portfolio to really find really novel solutions for our customers. And then, I don't know if more on sugar reduction or I can go to plant-based.

Adam Samuelson:

You can go to plant-based.

Jim Gray:

Okay, great. So then on plant-based, the one thing that we realized as we looked at plant-based is that when we separate corn, you're taking protein out of the corn kernel in your wet-milling process. So we've actually been quite knowledgeable on how to separate out a protein from a carbohydrate for a long time. And then when you get into plant-based, what we really liked was the demand within the US, particularly with younger generations, really being concerned about both sustainability and the impact actually affecting their initial food choices. So it's generating a lot of trial. And with that trial becomes some affinity towards different brands and therefore you get decent repeat.

Jim Gray:

So you're seeing that get a lot of traction. And so I think that's a mega trend. I think that's going to be generational with both millennials and Gen Z. And so we've made some significant investments into plant-based protein here in North America and just really progressing nicely, I think, on our two facilities, generating really big customer lists. And a lot of sampling, a lot of testing, a lot of trialing going on right now. And as we've said, we really see that as a nice revenue build for into this year, but really into 2022, 2023.

Adam Samuelson:

Okay. So maybe if we wrap that together. And I guess what I've candidly struggled with is trying to see the net impact of those investments and that growth in the aggregate portfolio relative to the base. And help us think, you have every year at CAGNY, you've had this multi-year plan that you've laid out. And it basically presumes the base business is flat in the multi-year build, and then the specialty is what drives the growth. And that hasn't really been the lived experience in the last few years. And I'm trying to understand why and where the confidence would come that it's going to be that way going forward.

Jim Gray:

Yeah. Well, I think on specialty first maybe. I'll answer in two parts. I'll try and be concise. I think with specialty, as we've invested in these new capacities, there is a bit of an operating income hit while these facilities are getting up to speed. And so some of that is we're enduring here in 2020 and 2021. And we'll start to see that curve and that revenue acceleration, which is nothing but then pure contribution margin towards covering those fixed costs. And so that's true for plant-based protein. And obviously in PureCircle, we've talked about the turnaround there and are making really nice progress with that as sales grow and just more contribution margin covering the fixed costs. So that's one. So that's in our starting point right now. And so as that turns, you see quite a bit of incremental, both revenue and profit growth impacts the algorithm so to speak. But then your second point is, hey, how do you think about the business being stable on the core? And part of the headwinds, candidly, that we had in the second half of '18 and '19 had been we'd gone from a really favorable corn market in North America or the US to something that was a bit more challenging with US-China trade and a separation of some of the co-product values offsetting the gross cost of the corn. Now we're in a more favorable co-product market with a lot of demand for soybeans, that's really then increasing the values of the corn gluten meal and the corn oil. So those are nice offsets. But I think more importantly, because, Adam, we always can talk about the US market because it's visible to us.

Jim Gray:

But out of our core, that's only 35% of our net sales. So 65% of our net sales is really coming from other countries where we have growing populace, and I like to say growing stomachs. We sell ingredients into food and beverage that's consumed. And so I really like our market share positions and positioned well in geographies, that for our core ingredients, I do think it's pretty reasonable to assume that we're going to get half a percent to one and a half percent growth in that demand in those markets. It's very aligned with population growth.

Adam Samuelson:

Yeah, okay. Okay. So maybe then thinking about what you do with that, so switching to cap allocation. How do we think about where you're deploying your capital going forward? And I guess one thing I've been struck by with Ingredion has been you mostly have been pursuing fairly bite-size or small enough tuck-in acquisitions. The leverage has always been pretty managed two times and below. But also the specialty percentage of the portfolio has been just creeping up one to 200 basis points a year. Do you have appetite to do something bigger to remix that faster? What would it take? And put another way, do you think you have enough capability in-house to effectively compete with the portfolio that you have?

Jim Gray:

Yeah. Well, definitely I think that we... And maybe I'll answer your latter question first. If I look at our positions in our businesses, whether it's in Europe or it's in Asia-Pac or here within the US and then growing specialties franchises in Mexico and South America, in terms of just the sheer number of food technologists and research, I absolutely think that we're very competitive. I personally think we're the global leader in food texturants. When we think about the M&A landscape and where we want to be able to accelerate along our specialty platforms, I think there's two things that are opportunities for us and then one that constraints us.

Jim Gray:

So the first opportunity is that we have a really extensive network as either a distributor partner, maybe a co-collaborator. And we usually develop our target list from folks who know us and realize that, hey, Ingredion is both a source of cash, but also a way of just continuing the franchise of the business that may be an owner-operator or a family begun, and they want to see its success. And so I can point to Western Polymer and KaTech and even to some extent PureCircle were all relationships that we had within the industry that time came along and it was time for an event and we were there well positioned.

Jim Gray:

The second piece is that with that, there's some adjacencies to what you're acquiring. So there's always going to be some synergy value, whether it's top-line or cost synergy. And so the thing that holds us back is always going to be the multiple and what's the premium that's required on a target. And necessarily when we work through the opportunity, is it something that's positive for the Ingredion shareholder relative to where we're trading? And so look, market multiples have been pretty high, what I would say 2018, 2019. I think 2020 had a bit of a respite, a brief pause. We closed two acquisitions in 2020. We closed PureCircle July 1st, 2020. So I thought we were fairly opportunistic. And yet, you still see multiples a bit elevated. So we're always going to be prudent around the multiple.

Jim Gray:

And your capstone is we'll look at any size, Adam. We really consider what can make sense in terms of, I think, accelerating the profile both from a relative market position, from a strategic position, and then also just maybe from a growth perspective, that everyone in your community would look at us and say, "You know what, this seems like a really well-positioned company that has longevity and has growth opportunities in front of it." That'll ground us in how we think about M&A.

Adam Samuelson:

No, that's really helpful. And the point on the multiple actually gets to the next question. It's actually a perfect segue. Just thinking about the value, merit of having those specialty pieces tied to that more core business. I'm thinking especially in North America, but Brazil and certainly in South America too. It probably would be a similar concept. There's been press reports of one of your competitors thinking about trying to separate those in some capacity. Help us think about the fit. Is that actually something you think is feasible? Or what's the value of putting the two together or keeping the two together?

Jim Gray:

Yeah. Well, the value of keeping the two together is where you have customer overlap and then where you have, in your cost structure, producing at one wet mill and having a product that's interstage, and then does it get moved to a different facility for finishing or for packaging or something like that. So there's no clean separation of these plants do that and these plants do only this. So you're always going to have this kind of crossflows of products that exist within any wet-milling network, my view. I don't really comment on competitors in terms of their M&A. I would just say that that competitor trades in the UK and may have a different shareholder roster, and that may make sense relative to the type of shareholders that they have. And so let's see how it plays out, but yeah.

Adam Samuelson:

Okay. And so I guess absent something there, just maybe we can close on this. Just as we think about excess cash from here, bolt-on M&A still seems like something you're pursuing, but how do we think about the appetite for share repurchase against that?

Jim Gray:

Yeah. Obviously, if Jim Zallie and the leadership team here are finding organic capital growth opportunities, and those are helping us target ROICs that are, we think, year two, year three, above 10%, those are very attractive to our shareholders from a long-term value creation. So we pursue those first. We think secondarily about the dividend, and we think the dividend is a nice return given some of the core portion of our portfolio. And then to the extent that we can deploy cash towards tuck-in M&A or just any M&A that we think is going to accelerate and strengthen the strategic position of the portfolio, that's where we're at, and we'll be doing that at return rates that are above our WAC. So then I think if that didn't exhaust all the cash available and/or the balance sheet capacity that we have, we can think about repurchase. We did some repurchase in Q1. And so we'll watch that and if it's opportunistic and we think that that's a right time to be acquiring shares back that's going to lead to a higher return for remaining shareholders, then we'll do that.

Adam Samuelson:

Okay. All right, great. Well, I think we're bumping up right against our scheduled time. So maybe we can, we'll leave it there. Jim, I want to thank you for taking the time. I want to thank everybody on the webcast for dialing in. And I hope everybody has a great day.

Jim Gray:

Okay, great. Thanks Adam. Appreciate it.

Adam Samuelson:

Thank you.

Adam Samuelson:

(silence)