Company Name: Chr Hansen Holding
Company Ticker: CHR DC
Date: 2017-07-05
Event Description: Q3 2017 Earnings Call

Market Cap: 66,519.58
Current PX: 504.50
YTD Change($): +113.40
YTD Change(%): +28.995

Bloomberg Estimates - EPS
Current Quarter: 0.514
Current Year: 1.671
Bloomberg Estimates - Sales
Current Quarter: 287.900
Current Year: 1065.563

Q3 2017 Earnings Call

Company Participants

- Cees de Jong
- Søren Westh Lonning

Other Participants

- Heidi Vesterinen
- Søren Samsøe
- Arthur Reeves
- Hans Gregersen
- Brett Hundley
- Michael Vitfell-Rasmussen
- Annette Lykke
- Fulvio Cazzol

MANAGEMENT DISCUSSION SECTION

Operator

Thank you for standing by and welcome to the presentation of Chr. Hansen Results for the First Nine Months of 2016/2017. At this time, all participants are in a listen-only mode. There will be a presentation followed by a question-and-answer session. [Operator Instructions] I must advise you that this conference will be recorded today, Wednesday, 5th of July 2017.

I would now like to hand the conference over to your speaker today, CEO, Cees de Jong. Please go ahead.

Cees de Jong

Thank you, operator, and good morning. Welcome, everybody. I'm Cess de Jong, CEO of Chr. Hansen; and with me is our CFO, Søren Lonning. Sorry for starting a few minutes late, we had some issues uploading the presentation.

We are quite satisfied with the overall performance for the first nine months. Food Cultures & Enzymes performed slightly better than expected while Health & Nutrition and Natural Colors delivered in line with the long-term ambition. Based on this performance, our outlook for organic revenue growth is narrowed to the upward end of the range at 9% to 10%, and it comes from 8% to 10%.

Looking at the third quarter, Food Cultures & Enzymes and Health & Nutrition showed strong growth whilst the growth in the Natural Colors division was negatively impacted by our continued pruning of low-margin business.

Our EBIT for the first nine months – our EBIT margin for the first nine months, I should say, also showed good progress. And that was driven by Food Cultures & Enzymes and Natural Colors while Health & Nutrition were below last year.

In Q3 however it was encouraging to see an improvement in the Health & Nutrition EBIT margin when compared to the first half of the year. The solid operational performance also has a positive impact on our cash flow. And as we are committed to distribute excess cash to shareholders, we will pay out an interim dividend of €100 million as announced today.

Before we move on, I would like you to take a look at the disclaimer on the next page. And I hope you've all had a chance to read the statements or will do so afterwards, so let's move to slide number 3, please.

In the first nine months of our current fiscal year, revenue reached €780 million, and that is 12% above last year. Organic growth, and that excludes NPC for the first six months, reached 10% in the first nine months. The organic growth was mostly driven by volume and mix while price contributed around 1% mainly due to higher raw material prices in Natural Colors.

In Q3, organic growth was 10% all from volume and mix and the positive effect from higher raw material prices, outside carmine in Natural Colors, was offset by a negative impact from the euro-based pricing. For the full year, we expect the impact of euro-based pricing to be neutral.

Food Cultures & Enzymes delivered organic growth of 9% in the first nine months with strong growth in cheese, fermented milk, meat and wine. Growth in cheese was driven by conversions in the U.S. and in fermented milk growth was driven by further penetration in China, where we now do see growth rates easing a bit due to a tough comparable from last year. In Q3, organic growth for Food Cultures & Enzymes reached 10%, supported by very strong momentum in bioprotection.

The organic growth in Health & Nutrition was12% driven by strong growth in animal health and plant health, while human health delivered solid growth in line with expectations. In the third quarter, organic growth for Health & Nutrition reached 14% driven by animal health, where we now see a more normalized market environment in most segments.

Natural Colors delivered 9% organic growth. Volume and mix contributed around 5% and price 4%. The price increases were driven by higher raw material prices and general price increases. And volume growth continues to be impacted by our pruning of low-margin business as we aim to improve profitability. In the third quarter, organic growth in Natural Colors reached 6% with volume and mix contributing around 5% and price 1%. The expected negative impact from price decreases in carmine was more than offset by price increases in annatto.

Now, for the group, the operating profit before special items increased by 15% to €217 million, and that is equivalent to an EBIT margin before special items of 27.9%. And that is up from 27.2% last year. The increase was driven by the higher sales volume and operational efficiencies.

In the third quarter, the EBIT margin, before special items, increased 0.9 percentage point driven primarily by animal health and Natural Colors, whilst Food Cultures & Enzymes also show an increase in EBIT despite the negative impact from higher production cost incurred for initiatives to secure full utilization of our existing production facility for cultures. Of course, this is ahead of, first, starting up the new capacity expansion, which we will do so in the fall of 2017.

R&D expenditures amounted to €55 million or 7% of revenue compared to 7.3% last year. Now, the decline, relative to revenue, was driven by cost related to the acquisition of a strain collection from Dairy Innovation of Australia, and that, of course, happened last year. Excluding this, we continue to increase investments in our strategic initiatives, including bioprotection and LGG.

Profit for the period ended at €156 million, and that is up 22% from last year. Finally, the free cash flow before acquisitions and special items reached €98 million, and that too is a solid improvement from last year.

Let's move to the next slide for an update on the strategic highlights for the first nine months. As you know, we've identified three key strategic initiatives, and we call them lighthouses, and those support the long-term growth of Chr. Hansen. I'm actually pleased to see the continued good progress across all three of these.

In bioprotection, we continue to see a strong interest for our solutions both in fermented milk, cheese and meat. Bioprotection increased with almost 40% in the third quarter taking the growth up to 30% for the first nine months. The growth is mainly anchored in both EMEA and North America. And we see strong interest outside these regions, and we will be able to address more of these markets with the launch of our second generation of bioprotective products towards the end of the calendar year.

Within plant health, we saw a strong growth in NEMIX C and we continue to see encouraging field trial results supporting the penetration. Outside NEMIX C, VGR continues to hold good potential whereas, for NEMIX, with a long introduction period. And that, of course, is not unlike our introduction of new innovations that we have in our large dairy business.

In the human microbiome, we've made solid progress as we from screening of over 1,000 relevant strains for the human microbiome have now identified 100 of those strains that can be developed for a broad array of health indications, for instance, associated with gastrointestinal, immune and metabolic health.

Now, the strains have passed the rigorous safety assessments and are amendable for production and formulation into products in an industrial setting. These strains will be used both for our internal innovation efforts and be made available to external partners that are looking to accelerate development of next-generation probiotics and live biotherapeutics. And even though we're very excited about these strains, I must remind you of the long development times for this area, and that is, while we do not expect material revenue from the human microbiome within the current strategy period running till 2020.

We continue to progress well on the expansion of the production capacity for cultures in Copenhagen. As I've mentioned, we've taken a number of initiatives to safeguard production volumes until we start up operation of this new production capacity during our first quarter of the next fiscal year.

Due to the positive development and continued growth for cultures, it has been necessary to add to our logistic cost to secure the delivery performance. Running at full capacity also means that we've reached the point where it's difficult to reap the benefits of scale as we right now do not have the flexibility to optimize our production processes. And that, of course, will improve once we have the new capacity fully implemented.

And then, our animal health business overall does quite well. And in the third quarter, we've seen market conditions normalize in most segments. However, both the beef cattle segment, which we entered with the NPC acquisition, as well as the dairy cattle segment continued to be negatively impacted by the challenging market conditions, and both are only gradually improving.

It is encouraging to witness the skilled execution of the insourcing of production from NPC. And that's contributed to the margin progression in the Health & Nutrition in Q3. And last but not the least, when it comes to animal health, I'm really very pleased to see our innovation efforts in animal health materialize in yet another great product.

GALLIPRO Fit, for poultry, is launched and made available to customers in the U.S. in August. And this is the first probiotic that offers a combination of three unique strains in one product that create a holistic solution to secure a healthy enteric system, which is the biggest challenge for the poultry industry today.

Finally, also we're highlighting is the good development to profitability for the Natural Colors where we're beginning to reap the benefits of the many profit-enhancing initiatives that were launched over the last 12 months. Many of the initiatives, such as pruning of low-margin business, taking out complexity by significantly reducing the number of SKUs, will continue over the next quarters. And with that, let's please go to the next slide.

Returning to the development in the first nine months of the year, then we delivered 7% organic growth in the EMEA region, and EMEA represents 43% of group revenue. The growth was driven by a strong growth in bioprotection, animal health and Natural Colors and also solid growth in cheese. In the third quarter, the organic growth was also 7% supported by strong growth in bioprotection, human health, animal health and solid growth in cheese and enzymes. Fermented milk, including probiotics, showed good growth in both Q3 and the first nine months, but fermented milk in EMEA is also impacted by the difficult market conditions in Southern Europe.

In North America, we saw 11% organic growth. There was strong growth across all segments, except fermented milk and enzymes, which showed more modest growth. And in cheese, we continue to see good progression in conversions of large U.S. customers. Organic growth reached 9% in the third quarter in North America with strong growth in all areas except human health, which was impacted by the timing of orders. In a difficult fermented milk market, it is great to see strong growth supported by very strong momentum in bioprotection, but also improving momentum in probiotics.

LatAm delivered 8% organic growth with strong growth in Natural Colors, animal health and plant health. In the third quarter, in LatAm, organic growth reached 7%, and that was supported by strong growth in animal health, plant health and probiotics for fermented milk. The organic growth was negatively impacted by the euro-based pricing due to the stronger Brazilian real, and that was only partly offset by the weaker Argentinean peso. Also, the tough market conditions in the region have had negative impact.

And finally, in Asia Pacific, we saw 19% organic growth, driven by strong growth in fermented milk, and that included probiotics but also by human health and animal health. The strong growth in fermented milk continues to be driven by China. Organic growth in Asia Pacific, in the third quarter, reached 21%, and that was driven by strong growth again in fermented milk including probiotics, human health and animal health. Growth in fermented milk in China was lower than in the first six months, and that, of course, is due to a tougher comparable.

And with this, I'd like to hand over to Søren to go through the financials of each of our businesses.

Søren Westh Lonning

Thank you, Cees. Let me start with Food Cultures & Enzymes where the strong momentum for the first six months continued in Q3 with 10% organic growth thereby bringing organic growth for the first nine months to 9%, all from volume and mix.

Q3 saw a small negative impact from the use of euro-based pricing term by the strong Brazilian real. The volume growth of both the first nine months and Q3 was primarily driven by strong growth in cheese and fermented milk with both segments supported by very strong momentum in bioprotection.

Cheese was also driven by conversion of large U.S. customers, while fermented milk was supported by further penetration of both ambient and regular yogurts in China. It is also encouraging to see enzymes back to solid growth in Q3. Due to the better-than-expected performance in Q3, we now expect the growth in Food Cultures & Enzymes to end slightly above the 7% to 8% long-term ambition.

The EBIT margin for the first nine months is now 0.8-percentage-point above last year driven by scalability and production, however, partly offset by the initiatives to secure volume ahead of the new production capacity coming live in the fall as well as higher R&D cost for bioprotection and LGG.

In Q3, the EBIT margin increased by 0.3 percentage point driven by scalability in the operating cost base and improved scrap levels. This was partly offset by initiative to secure full utilization of our existing capacity and an unfavorable product mix. We do continue to expect a slight increase in the EBIT margin for the full year, implying a decrease in the EBIT margin in Q4, while the baseline of last year also will become tougher.

Let's turn to the next slide and look at Health & Nutrition [indiscernible] (16:14) and are now, for the second quarter in a row, back to the long-term ambition of double-digit growth. Organic growth for the first nine months is 12% with strong growth in animal health and plant health as well as solid growth in human health.

Animal health was primarily driven by customer wins in silage and poultry, with swine also showing positive momentum. Both beef and dairy cattle continue to be negatively impacted by these market conditions, especially in the U.S., while the market conditions have now more or less normalized in the other segments.

Human health showed solid growth supported by both dietary supplements and infant formula. We do expect growth in human health to pick up in Q4 driven by timing of customer product launches, as also previously communicated.

Turning to the EBIT margin, we did see an improvement in Q3 of 1.1 percentage point compared to last year driven by the insourcing of NPC products and the discontinuation of NPC's traded products, which were transferred to other operating income in Q4 last year. As a consequence, the latter effect will reverse in Q4.

The EBIT margin for the first nine months is still down compared to last year, primarily driven by increased activity to support the strategic initiatives including LGG and higher depreciation and amortizations related to the acquisitions. Please turn to the next slide.

NCD delivered 9% organic growth in the first nine months with volume and mix contributing 5-percentage-point and price 4-percentage-point. Organic growth reached 6% in Q3 with price contributing 1-percentage-point and volume 5-percentage-point.

Volume growth, outside the carmine category, remained in line with the long-term growth ambition of around 10%. The impact from pricing was reduced in Q3 as raw material prices for our largest pigment, carmine, has been declining. However, the effect from carmine was more than offset by increase in pricing for annatto seeds, which is used in many of our orange shades. The organic volume growth was primarily driven by strong growth in the natural carotene, annatto and anthocyanin pigments while carmine volume continued to decline due to profitability initiatives. Growth was anchored across most industry and especially driven by North America where we continue to see double-digit growth from the ongoing conversion.

The EBIT margin increased by 1.7-percentage-point in both Q3 and in the first nine months of the year. This has been driven by the ongoing optimization initiatives, including margin management and operating efficiency as well as positive timing from inventories, which we expect to partly reverse in Q4.

Let's move to the next slide. Looking at the group results for the first nine months, we have delivered 12% growth in euro, which is equal to an organic growth of 10%. Of the 10% organic growth, volume and mix has accounted for 9-percentage-point and price for 1-percentage-point. Acquisition have added another 2% while the impact from currency was close to 0%.

Q3 showed an organic growth of 10%, all from volume and mix as the expected negative impact from using euro-based pricing was offset by higher raw material prices in Natural Colors. The gross margin has improved 1 percentage point to 53.8% driven by improvements in all business areas. And this has also benefited the EBIT margin before special items which has improved by 0.7 percentage point to 27.9%. €1 million in special items related to LGG and the announced closure of the acquired factory have been realized so far this year.

Let's take a closer look at the cash flow on the next side. The cash flow from operating activities has year-to-date improved by €45 million, while the cash flow used for operational investing activities has increased by €8 million, largely due to investments in capacity for culture production.

All in all, this has resulted in a free cash flow before acquisitions activities of €91 million year-to-date. On top of this, we have also spent €73 million in Q1 on the acquisition of LGG and the related businesses. The capital expenditure, excluding the acquisition, corresponds to 9.2% of revenue, which is above last year, as we have increased the investment level this year.

Return on invested capital excluding goodwill has increased by 1.4 percentage point, while the net interest-bearing debt-to-EBITDA ratio has been lowered to 1.8 times despite the acquisition of LGG.

Please turn to the next page. With a strong nine months behind us and a slightly better than expected performance in Food Cultures & Enzymes and Health & Nutrition, we are narrowing the expectation for organic growth to the upward end of the range, so 9% to 10%. This also implies that we now expect organic growth in Food Cultures & Enzymes to be slightly higher than the long-term ambition of 7% to 8%.

The impact from higher comparable in China has been offset by, among other things, the very strong momentum in bioprotection. We continue to expect a slightly negative impact from euro-based pricing in Q4, resulting in a close to neutral impact for the full year. With the increase in the Natural prices, we now expect a small positive effect on organic growth from raw material prices in Natural Colors for the full year. We are maintaining the outlook for EBIT margin before special items as being slightly above last year. The free cash flow is still expected to be around the same level as last year due to high investment levels in Q4 compared to last year.

Please turn to the next slide. We do remain committed to our capital allocation priorities, implying that additional cash will be distributed to shareholders if no acquisition materializes. Chr. Hansen is not depending on making acquisitions and remain very selective in this area. That being said, we have a number of identified bottleneck targets, which we, at the right time, at the right price and with the right willing seller could materialize.

The actual allocation will continue to be guided by our ambition to maintain a leverage in line with a solid investment-grade credit profile. For the time being, we aim to not exceed 2 times net debt-to-EBITDA on a quarterly basis and thus end the year around 1.8 times EBITDA. Based on this, the board of directors has decided to declare an interim dividend totaling €100 million corresponding to DKK 5.64 per share. This would be paid out on the 13th of July.

And with this, I will hand over to the operator to start the Q&A session.

Q&A

Operator

Thank you. [Operator Instructions] Your first question comes from the line of Heidi Vesterinen. Please go ahead.

<Q - Heidi Vesterinen>: Thank you. So, first, on Cultures & Enzymes. So, it's now the third year in a row where we're saying that growth will be above long-term guidance. So, can you just take us through why the guidance is 7% to 8%?

And then another one on bioprotection. So, this accelerated quite nicely in Q3. Was this mainly in dairy or did you expand your market? You were talking about salmon, for example, in the past. And have you seen any changes in the competitive landscape? I think last quarter you had talked about one newcomer emerging in the market. Thank you.

<A - Søren Westh Lonning>: Let me address that, Heidi. You are right that we, over the course of the last couple of years, have been fortunate to exceed our long-term guidance in Food Cultures & Enzymes, but we also had some specific drivers behind that. We have seen in 2016 a very favorable impact from euro-based pricing that was abnormally high. We have seen milk volumes being quite high. And then we have seen China growing phenomenally, and also, higher than a level that we can hope and expect to continue going forward. So, when we look forward, we maintain that 7% to 8%, that is the right long-term financial ambition for Food Cultures & Enzymes, that reflects the factors that I've pointed to here that we expect a normal situation in those areas and that we expect a continued strong momentum in bioprotection.

When we look to the strong momentum in bioprotection, it has indeed been dairy more than anything that has been driving the strong development. We've made good wins in both Europe and North America in particular then we also have started to bring in some wins outside of these regions in Latin America as an example. So, it has indeed been the dairy part that has been driving the growth and less new areas.

<A - Cees de Jong>: Maybe to add a few words on bioprotection because you specifically asked also to other food products. As Søren is saying, the growth is still primarily coming from our traditional area, so it's dairy, it's fresh fermented milk, it is cheese and there is meat that drives it.

We're working with the regulators to get a more easy landscape to introduce products more broadly outside those fields. Now, the win in LatAm is an interesting one that we made because this is one of the first where one of our customers is capable of taking out a chemical preservative and replace it by our bioprotective solutions.

And the good news is this is still our first generation product. We believe that we are definitely the strongest in the market when it comes to the bioprotective power of our solution. Last time, indeed, Heidi, we talked about a new entrant. We think it's only a confirmation to the importance and attractiveness of this segment. And the second generation products, we will be introducing in the fall of this year before calendar year-end.

<Q - Heidi Vesterinen>: Thank you.

Operator

Thank you. Your next question comes from the line of Søren Samsøe. Please ask your question.

<Q - Søren Samsøe>: Yes. Hello, gentlemen. Søren from SEB. First, if you could just tell us how much of your R&D cost has been capitalized in Q3 and in the first nine months? And secondly, if you could tell us where the LGG is included in the organic growth for Q3?

And then finally if you could comment on how many or quantify how many new sales projects you have this year versus last year? That were my questions. Thank you.

<A - Søren Westh Lonning>: I'll take the two first questions, Søren. When we look to the R&D capitalization both in Q3 and year-to-date, we are very close to 1% of net sales, marginally above that but that's the level and it's been quite constant during the year.

When you look to your questions regarding LGG, LGG is not influencing organic growth in Q3 or in this year. Remember, we acquired LGG in November last year or closed the deal in November last year. So, we will not have any impact on LGG until we cross that line in Q1 in the next financial year.

<A - Cees de Jong>: Going to your last question, it's obviously the most difficult one, that's why Søren is pointing at me. I don't think we've ever disclosed the number of sales projects but let me try and give you an indication, Søren, of how things look, and I'm going to limit myself to Food Cultures & Enzymes.

When you would assess Food Cultures & Enzymes in EMEA, we need to win about 1,000 sales projects every year to make our growth. So, it shows you that this is a business that is built on many small steps and to us that is both an advantage and a disadvantage. It obviously creates some complexity, and we need a quite sizable sales force. On the other end, there's not a single project that can make or break our growth rates.

If you were to look in R&D, there, of course, the numbers are completely different. What we try to do, and again, I'm only talking Food Cultures & Enzymes, we try to create platforms on which we grow. So, the 1,000 sales projects for instance in EMEA, they would be based on a very limited number of important platforms. And there, in any given year, and I'm going to take a range here because competition might listen in, you need to think that we have anywhere between 8 and 15 different platforms that we're working on. And a platform would be, for instance, us introducing a new and better enzyme as an example.

I hope that answers your question, Søren.

<Q - Søren Samsøe>: Yeah. Yeah. But if you could just expand a little bit. I mean, is this – so, the [ph] Solvin (30:48) project, is that more or less than last year? And then, secondly, are these projects, are they mostly towards you can say existing customers or are you also – do we also have a lot to new customers just to sort of get an understanding on how you're working?

<A - Cees de Jong>: Yeah. Obviously, it's a mix, but the large majority is existing customers where we continue to drive innovation. And remember what I said before in Food Cultures & Enzymes and this is not exact science, but probably about two-thirds of what we do is still also improving production processes at our customers. And sometimes that will have an effect on the end product. Acidifix is a good example, and it gives both a mild yogurt where there is a massive benefit for the customer also when it comes to their production. And then what you have to take into consideration is that sometimes we still make significant growth on platforms that were introduced 10 years ago.

So, Chr. Hansen is not a business where a single platform or a single project all of a sudden will make or break our growth rates. Even bioprotection is a platform as an example. It's around 5%, a little bit more probably now of our sales. Also, that consists, once we have this platform, of many individual sales projects where we tailor the products that we sell to a customer to their specific situation. So, you will not find one, let's say, solution in all of our customers' products and processes.

<Q - Søren Samsøe>: Okay. Thank you.

<**A - Cees de Jong**>: Thank you.

Operator

Your next question comes from the line of Arthur Reeves. Please ask your question.

<**A**>: Operator?

Operator

Arthur, your line is open.

<**Q - Arthur Reeves**>: Can you hear me?

<**A - Cees de Jong**>: Now, we can.

<**Q - Arthur Reeves**>: Good. Sorry about that. Two questions from me, please. The first to do with human microbiome. I know you said that you don't expect to monetize that during your current medium-term plan. But how will you monetize it, please?

And my second question is about Natural Colors. You talked before about potentially using Natural Colors in yogurt in China. Can you give us an update on that, please?

<**A - Cees de Jong**>: Yes. Let me take those questions, Arthur.

<**Q - Arthur Reeves**>: Thank you.

<**A - Cees de Jong**>: In microbiome, we have two ways to monetize on that market opportunity. The first is that we do what we also do in dairy and that is that we will be providing solutions from manufacturing to the companies that are going to be active in the microbiome. And those companies can either be pharmaceutical companies, they can also be food or nutritional companies. Think a Nestlé or a Danone for example.

Those companies come to Chr. Hansen with strains that they have identified and they need to have them produced. And that is the outsource model in a way that we've also been running in dairy, that's one way to monetize. The other is that we use our own strain collection to bring strains to what we call proof of concepts. So, we know or we think that there's a clinical benefit of certain strains. We have the opportunity to nowadays test that in the lab in something what is called organoids. It's basically small tissues or organs that work in a test tube, we can test there and then we can immediately go into humans.

We do small scale proof of concept trials. So, think 50, 70 subjects. And once we've achieved proof of concept, we bring those proprietary strains to, again, sort of the same parties that may take those to market. Either pharma companies or nutritional fresh food companies. So there's two ways to monetize. Now, given the clinical trajectory that still has to take place in both ways, we don't want to put numbers on them. Definitely, this will not contribute in any materiality towards revenue before 2020.

I will now talk about Natural Colors. Indeed, in China, we see in the dairy space premiumization going on. So, we do have some first sales in, let's say, more premium-type fermented milk drinks.

<**Q - Arthur Reeves**>: Okay. Thank you very much.

Operator

Your next question comes from the line of Hans Gregersen. Please ask your question.

<Q - Hans Gregersen>: Good morning, three questions. Bioprotection, can you shed a little bit more light on what's driving the growth acceleration we have seen in Q3? Is it new customers, new application or is it just a broader market reception of the product?

Secondly, we are now approaching the year-end of your business year. Can you give some thoughts also perhaps going beyond the current business year about the U.S. conversion outlook?

And then, thirdly, on plant health. We are now coming into the reality of a massive consolidation in the seed industry and also, let's say, product chemicals, et cetera. Can you give us sort of a quick strategic business review of how do you see this and the growth outlook over the next two or three years? Thank you.

<A - Cees de Jong>: Wow. That's a lot of questions. Let me see if I can answer them. On bioprotection, indeed we've seen fantastic growth, 40% in the third quarter. The simple answer would be to say our solutions work so well, but let me give you one example.

We've won a big product, which is a sour cream product that is sold in big pots. And what happened is that people spooned those products. So, they put a spoon in and then they put a bit of sour cream on whatever food they want to use it for. And sometimes, they then put the spoon in their mouth, right? They lick the spoon or they eat from the spoon, and that means that those products normally are quite susceptible to getting molded. We have been able to provide a solution for the customer in question that enables them to prevent this molding, and they've never been able to do it before. It's a big brand in a big geography. So that's a key driver. Those type of things drive our growth in bioprotection.

When it comes to giving any guidance beyond year-end, we obviously don't do that at this stage. But what I'm willing to say about U.S. conversion is that Natural Colors has been growing double digits in the U.S. for the last three quarters.

So, we do see conversion going on. And what we've also said before at calls like this is that for the big players, it was publicly announced that they are converting, it is a massive task to get this done. Because again, let me remind you, it's not just about getting the artificial color replaced. It's also about getting natural flavors in and getting artificial ingredients out.

So that means that this continues to be a process that takes time and it's exactly what we're seeing. At the same time, what we do see is we do see new fast food chains announcing that they also want to go all-natural, so the trend is really out there.

And again, let's – all of us, remember, we live in a world of total transparency. Consumers nowadays know and are aware what they put in their mouth and there's no way going back for the large producers.

Then when it comes to plant health, again, I'm not going to give any sort of outlook beyond year-end. But remember what we said in plant health. In plant health, we said that we would carve out some attractive niches where we feel that our solutions can really work.

And when I look at the field trial results that we've obtained, but also the introduction with some new products that we're now introducing, I'm really very pleased with the progress there. I also need to say that in certain markets, the adoption rate is a long process because of the regulatory hurdles that need to be taken.

So, some of the products where we now have regulatory clearance, we basically started the registration process from two years ago. We do see that consolidation. It does not change our strategy nor our ambition for this field. Thank you, Hans.

<Q - Hans Gregersen>: Could I just ask, in terms or bioprotection, have you lost any projects? And finally, on your last answer, plant health, is it fair to conclude that the, let's say, commercial development of plant health has gone slower than expected? Thank you.

<A - Cees de Jong>: Let me take your last question first. I think we have communicated to market already at the Capital Markets Day that when we launched the NATURE'S NO. 1 strategy back in 2013, we would have expected the sales to come a bit earlier than we're currently seeing. And that's something that we communicated at the Capital Markets Day last year. And I think it's fair to say that, back in 2013, we had underestimated what it would take to get projects registered.

Our ambition, when it comes to the power of the all-natural solutions, is absolutely unchanged. And I can't talk about all of our pipeline products, but let me just, for one second, again, talk about NEMIX C on sugarcane.

Some of the chemicals that have been used on sugarcane, and they're banned in many countries but still allowed in some others, those chemicals have the same structure as nerve gases. That's the stuff that we put on our food, right? So, we need the workers, that are using those chemicals, they need to wear protective equipment when they use those chemicals. I mean, come on, consumers will no longer want it on their foods. And then when we look at the biological solution that we provide, it's actually working better than the chemical. So, our ambition, in terms of long term bringing those products to market, is definitely unchanged.

When it comes to bioprotection, we've not introduced the new generation yet. We will introduce the new generation in the end – towards the end of this year in the – I think it's the first quarter of the next fiscal year. And, again, the next-generation bioprotective solutions is even more powerful than the current products that we have on the market. And we are convinced that our current products are already the best on the market.

<Q - Hans Gregersen>: But my question was, have you lost any projects with the customers to competitors?

<A - Cees de Jong>: We don't comment on customers and competition as you know.

<A - Søren Westh Lonning>: But you can do the math and look at the growth, and once you – if there would be any, it will be a very, very small amount, so.

<Q - Hans Gregersen>: Okay. Thank you.

Operator

Thank you. Your next question comes from the line of [ph] Glenn Gorman (41:58). Please ask your question.

<Q>: Hi, guys. Just a few quick ones for me. First of all, on bioprotection again, let's go back to that. Can you comment at all on the sort of investments in your margin there in terms of the sales capabilities and what you expect for this year sort of incremental margin-wise over the next few years?

And secondly, on the underlying cultures business, and just sort of breaking that out a little bit. Have you seen any particular change in the make-up of your growth between customer outsourcing and innovation-driven growth or the underlying market?

And then, just finally, the third one, in terms of the additional cash return this year, your €100 million additional, should we consider that [ph] bit (42:47) for this year or could there be sort of extra additional dividend at the end of the year? Thanks.

<A - Søren Westh Lonning>: Okay. Let me try to answer your questions. In terms of the bioprotection, I mean, if you look to the EBIT margin in Food Cultures & Enzymes, where you will see the impact of the investments that we made in this area, we are referring to in our year-to-date margins that we have a negative impact from higher R&D. It is to the tune of 0.5 percentage point, and this includes both bioprotection and LGG, which also required some mix of manpower in order to make this happen. So that's the level that we are talking on.

You will also note that when we look to the Q3, we're actually referring to efficiency from the operating cost base. And it means that part of the manning up that we did, we did as part of launching the updated NATURE'S NO. 1 strategy last year. So now, we are starting to see that several of the persons that we brought on-board in R&D had now been here for a year's time. So – but that's roughly to say something to the effect of that. So, it is relatively limited compared to the growth potential that we are seeing here at the investment levels.

If you talk to change in the growth model, as we've always said in Food Cultures & Enzymes, the numbers that we have in our growth model that is indicative and they can change from a year to a year. So, what we would be seeing this year is that the conversion of – in cheeses in particular is driving us to be in the [ph] upper (44:31) end of the range, 1% to 2%. And that's a consequence about being very successful than the U.S. on this parameter.

If you look to the innovation part where we also guide 1% to 2%, we would also be in the high end and even maybe slightly above because we label the bioprotection in here and it actually adds more than 1-percentage-point in itself.

On the other hand, pricing is due to the euro prices, et cetera. Here, we are more between zero and 0.5 this year. And it means that we're in the low end of that part. So, there is a little bit variation but it's within what I would expect as an annual variability to our growth model in Food Cultures & Enzymes.

If you look to the cash return then the €100 million, that's the amount we have ended on, and we have ended on this because we want to be at around 1.8 times net-debt-to-EBITDA at the year-end. So, it means that, given that that's still the ambition, that means that this is it for extraordinary dividends this year. Then we will do ordinary dividends when we have the annual general assembly. And then, of course, we will check – I'll look again at the situation during the next financial year, but, no, you should not expect any further extraordinary dividends in this financial year.

<Q>: Great. Thanks.

Operator

Your next question comes from the line of Brett Hundley. Please ask your question.

<Q - Brett Hundley>: Hi. Thank you. Good morning, gentlemen. I have two questions. My first is on Natural Colors. Margins there were about 100 basis points better than I had expected, and it seems like you're starting to realize some of the mid-teen margin goals you had set out for that business. Do you guys feel like you are running ahead of schedule in any way in realizing these margins? Do you think that margins, where they are today, are sustainable going forward? Can you give us some – shed some light on that for us?

And then, secondly, on your facility expansion in Copenhagen, should we expect that when Q1 2018 rolls around that we will start to see some negative impact in your Cultures & Enzymes margins from reduced operating leverage? I would imagine that, as you ramped production and sales of this new capacity, that you may see some negative margin impact from that reduced operating leverage. Perhaps you can offset it in other areas, but I wanted to see if I could get some color on that as well. Thank you.

<A - Søren Westh Lonning>: Yeah. To the first point, on Natural Colors, you're right that margin was to the favorable side in this quarter in particular. What I would say though is that, as we also allude to in the comments, in the document, is that we also had a little bit of favorable timing in Q3 on inventory, and part of that will reverse in the Q4.

So, you should not just extrapolate the level that you saw in Q3 and expect that to be the level going forward. That being said, we are pleased with the progress that we are seeing in the margin expansion. That's overall close to where we expected to be now. But it's not our ambition to stay here. Going forward, we have said that we are targeting to be in the mid-teen range for Natural Colors, so that will imply 15% plus/minus a little bit and that's still the ambition.

We will not get there in one step. It will be a gradual improvement process over the coming years. But I think we have taken very important steps over the last two, three years in making this happen. So, a little bit of a favorable timing, but otherwise, in line with the plan that we have and we continue to expect improvement.

As to the question regarding the facility in Food Cultures & Enzymes, you are right that we will – once we start taking this into operation, we already now manning up to have the persons on board, so we will already in Q4 feel a little bit of that. But we are bringing in the manning. We will start depreciating on the equipment towards the – in – during Q1.

So, there will be a negative impact from that. We have said also that for the year, in its entirety, FY 2018, we believe that the impact from the new capacity will be neutral to our EBIT margin, and that's still the case. But we will have a little bit more headwind you can say in the beginning of the year, and then we expect to gradually improve as we bring it into operation and we also start filling it up more.

But I think the key message is really to say that we expect it to be a neutral around flattish impact on the margin of Food Cultures & Enzymes next year.

<Q - Brett Hundley>: Thank you.

<A - Søren Westh Lonning>: Thank you.

Operator

Thank you. Your next question comes from the line of Michael Rasmussen. Please ask your question.

<Q - Michael Vitfell-Rasmussen>: Thank you very much. Two questions, please. First, if you could add a couple of words on CapEx both in the fourth quarter and also going forward. Yeah, I'm thinking beyond the fermentation capacity, are you looking into freeze-drying capacity and so on?

My second question is basically on the net working capital. Typically, we see Q4 as a positive €20 million to €45 million impact. I think, particularly in Q4 of last year, it was quite positive. Now, can you please talk about the moving path forward for this year? I mean, is there anything changing the inventories or anything like that as the new capacity soon coming online? Thank you.

<A - Søren Westh Lonning>: Yeah. Yeah. I think when you look to the outlook on CapEx, it's also comparing to last year. Last year, we had a very low investment level in the Q4, which also created a very strong cash flow. This year will be different. We are, right now, completing investments, in the process of completing several investments, most importantly the expansion in the Copenhagen site. And that will add quite significantly to the investment level in Q4.

As we said in the guidance – sorry, not in the guidance, but the level should be expected in – for CapEx for the year, we are expecting above 9% and we probably – we could come relatively close to 10% for this financial year on CapEx. So, it means that we will have a quite substantial investments level on CapEx in Q4.

If you look a little bit ahead, when you're growing 10%, of course, we need to also to make sure that the infrastructure and the production facility mirrors that. And it means that we need to make investments also going forward. It will be reduced relative to sale compared to what we have seen or will see in FY 2017, but it is – will still be a material amount that we need to invest. So, that's my comment on CapEx.

If you look to net working capital, we always, in the business, as you point out, have a positive timing in Q4 related to the fundamentals of the business. We had that last year. We had that for many years. We will also have a, you can say, a positive impact in this Q4, but it will not be to the level of what we saw last year. I think that's important to bear in mind. We had a very favorable timing, extraordinary favorable timing last year in net working capital.

So, it means that we will also, when you project the free cash flow for the year, et cetera, we will also be doing less well in Q4 in the absolute numbers on free cash flow from net working capital. So, both, especially CapEx, but [audio gap] (53:18) will reduce the quite sizeable progress compared to last year we made year-to-date.

<Q - Michael Vitfell-Rasmussen>: Great. Thank you so much, Søren.

Operator

Thank you. Your next question comes from the line of Annette Lykke. Please ask your question.

<Q - Annette Lykke>: Yes. Thank you very much. Just on the launch of the new bioprotection products, first of all, could you share with us if you expect to expand it into other applications? And also, on a regional basis, it has been Europe and U.S. and you mentioned LatAm as an area you also have seen, but I was wondering about the APAC, on particular, China. Also, on the launches of the new products, what should we expect in terms of prices or margin from this?

Then on – I'd like to just see your more broader view on the sluggish growth in the Southern Europe for Cultures. Can you tell us if you see this to continue or if we should expect this as a situation to also looking forward? Thank you.

<A - Cees de Jong>: Annette, let me take your last question first and I remember also saying a few words from bioprotection. But when it comes to the sluggish growth in the south in fermented milks and yogurts, it's something we also see in the United States. And actually, what we're doing – what we're trying to do is to help our customers to, again, innovate in those segments because it's not good when they continue with just the existing products. And then, especially in the U.S., we see this fight one another on price. So, we've got projects started internally where both our innovation and our marketing people are now working to come up with solutions.

Will that turn around and when will that turn around? It's obviously dependent upon how successful we will be, A, in developing a new concepts; B, in getting our customers to accept them. When I look in the U.S. market, I do see an operation going on, but it's with really small customers and of course, the big ones who really can drive the market.

When it comes to your first question on bioprotection, again, back to other applications first. It'll take time before the regulatory landscape is such that we can broadly get into other applications. There is some niche applications that we're in today, but it hardly moves the needle. And it really is us working with the regulators to get that changed.

However, the second part of your question was on reasonable penetration and, indeed, our second-generation bioprotective solutions enable us to go into markets where, today, relatively harsh chemicals are being used to keep the products fresh and safe. And I think consumers are not always yet aware that those chemicals are in, but it gives the dairy producers, who still use those products, those chemicals, a perfect opportunity to replace it with all natural solution. And then indeed, you need to think about markets in Latin America but also Asia, and that is where indeed we're testing our products.

And Søren, you want to say a few words on margin?

<A - Søren Westh Lonning>: Yeah. Maybe let me address your margin question. When we launch new products, we always try to price them after the value that we create for our customers and they get a part of that. And that will also be the case for the second generation of bioprotection. However, we will try to offset that compared to what the existing product that we have on market for this applications.

More importantly, I think it is also to note that the bioprotection category as such, among the different products that we are selling in Food Cultures & Enzymes, are among the highest margin products. So, the high growth that we are seeing in bioprotection is helping driving margin improvements as such, and we expect that to continue also going forward.

<Q - Annette Lykke>: Okay. That was helpful. Thank you very much.

<A - Cees de Jong>: Operator, we have time for one last question.

Operator

Okay. Your next question comes from the line of Fulvio Cazzol. Please ask your question.

<Q - Fulvio Cazzol>: Yes. Good morning, gentlemen. Thank you for taking my question. Most of them have been answered. I've got two more. In the Health & Nutrition, can you provide us with some details on the revenue growth components? I think you delivered 14% organic growth in Q3, but the reported growth was 11.6%. So, I presume currency was a significant drag, so if you can just highlight exactly what happened there.

And then my last question was going to be on what's the next bottleneck. Once you've installed the new fermenters, what's going to be the next critical project in order to secure sustainability of strong top line growth? Thank you.

<A - Søren Westh Lonning>: Thank you for your question, Fulvio. When we look to the growth in Health & Nutrition in Q3, we, as you said, grew organically by 14%. Actually, currency added further to the growth to the tune of around 2%, almost 2%. What is influencing negatively and why the number is lower than the organic growth, when you look to euro growth, is that the acquisitions actually impacted negatively by minus – around minus 4%, and that's the reflection of it. But of course, we had a bit of positive impact from LGG but it really relates to the NPC traded product that we had in the sales in Q3 last year but where we have chosen to discontinue. And that takes down by almost 4 percentage point.

Now, as you may also recall, in Q4 last year, we did make the [indiscernible] (59:28) and reclassified this to operating – other operating income with effect for the entire year. And this means that it will – that project, the effect, the minus 5%, will reverse when we get to Q4. So, that will be neutral for the year. But I can understand why you raised the question.

So, there's a little bit of dynamics between Q3 and Q4 here, but it will not – it's not something that structurally impacts the division for the year. And currency was also positive in Q3.

To your second question regarding what's the next bottleneck here, we will – fermentation, what we have expanded right now is fermentation capability in Food Cultures & Enzymes. We will also – looking at the downstream part, not of the fermentation but in terms of packaging, so we will be looking into both what to do with freeze-drying and what to do with the freeze – various packaging formats. So, that will also something to consider over the coming years.

And then, of course, Food Cultures & Enzymes are not the only areas where we also consider needing to expand capacity. We are also working on expanding the capacity in the human health area, which has shown strong growth. And also, in Natural Colors, we are also making some reflections of how to make sure that we have the right platform for reaping the conversion that happens in North America.

So, those are some of the key investment considerations that we have right now, and we need to decide on in the coming time.

<Q - Fulvio Cazzol>: Great. Thank you very much for that.

Cees de Jong

Thank you, operator. As far as we are concerned, that concludes our call this morning.

Operator

Thank you. Thank you for participating. That concludes our conference for today. You may all disconnect.