

STEPAN COMPANY
Moderator: James Hurlbutt
July 20, 2005
1:00 pm CT

Operator: Ladies and gentlemen, thank you for standing by, welcome to the Stepan Company, second quarter 2005 earnings conference call. During the presentation, all participants will be in a listen-only mode. Afterwards, we will conduct a question-and-answer session. At that time, if you have a question, please press the 1 followed by the 4 on your telephone.

As a reminder, this conference is being recorded, Wednesday, July 20, 2005.

I would now like to turn the conference call over to Mr. Jim Hurlbutt, Vice President, Finance, Stepan Company.

Please go ahead, sir.

James Hurlbutt: Good afternoon and thank you for joining us.

Before I begin, please note that information on this conference call contains forward-looking statements, which are not historical facts. These statements involve risks and uncertainties that could cause actual results to differ materially, including, but not limited to, prospects for our foreign operations and certain global and regional economic conditions and factors detailed in the company's Securities and Exchange Commission filings.

I will now take a few minutes to review our operating results. Net sales for the second quarter of 2005 increased 18% to \$278.4 million from \$236.4 million for the same period in 2004.

An increase in sales volume and higher selling prices accounted for the increase in sales. Higher selling prices reflect price increases brought on by rising raw material cost.

Net income increased to \$6.2 million, or 64 cents per diluted share, for the second quarter compared to \$3.8 million, or 39 cents per diluted share, a year ago. Gross profit improved by 14% to \$34.7 million.

The increase in raw material cost also resulted in a last-in-first-out inventory charge of \$1.0 million after tax for the second quarter, compared with a charge of \$0.5 million for the second quarter in 2004.

Operating income increased 47% to \$10.5 million for the second quarter of 2005 from \$7.1 million for the same period in 2004.

Now, I would like to highlight the performance in each of our three segments, beginning with surfactants, which account for approximately 74% of the company's sales for the second quarter of 2005. Surfactant sales increased 14% from higher selling prices and an increase in volume in North America, Europe, and Latin America. However, surfactant earnings declined slightly due to higher operating expenses and a weaker sales mix in North America and lower margins in Europe.

Turning to our polymer segment, which represents 23% of our revenue for the second quarter of 2005, we saw polymer sales rise 33% in the second quarter due to higher selling prices. Higher margin polyurethane polyol sales volume declined on weaker demand. However, the volume of phthalic anhydride and polyurethane systems improved.

For the second quarter, polymer earnings improved in all product lines due to a recovery of margins previously eroded by higher raw material costs. In addition, a large polyurethane system order was entirely shipped during the second quarter.

And finally, our specialty products group accounted for 3% of the company's second quarter 2005 sales, increasing by 8% from higher volume of pharmaceutical ingredients. This segment should continue to recover over the balance of 2005.

Turning to expenses, the increase in marketing and research expense was largely due to higher salary, healthcare, and pension expense. Administrative expenses decreased by 18% primarily due to a \$1.7 million pre-tax decline in deferred compensation expense.

Looking at other income, interest expense increased due to higher average debt levels and higher short-term interest rates.

Regarding our Philippine joint venture, income declined during the second quarter due to an adverse change in lower margin product mix. A new fabric softener reactor currently under construction in the Philippines will benefit earnings during the second half of 2006.

Turning to the balance sheet, total debt at June 30, 2005 was \$133.4 million, up from \$112.0 million at the end of 2004. Our total debt to total capitalization at quarter end was 44.1%, up from 43.0% at the same time last year.

Capital expenditures were \$11.6 million for the second quarter. Year-to-date capital expenditures are \$19.8 million and should run slightly higher during the second half of 2005.

Looking ahead, we expect continued improvement in polymer and surfactant earnings. Surfactant sales mix is projected to improve and will also benefit from increased sales of bio-diesel.

High crude oil prices and favorable tax credits have created a market for soybean-based bio-diesel produced in existing Stepan manufacturing assets.

Surfactant sales grew over the quarter and have been successful in recovering higher raw material and freight costs in North America, though we've met some greater resistance in Europe.

But overall, we remain confident in our strategy and continue to be optimistic about our full year earnings growth.

This concludes my prepared remarks. At this time, I would like to turn the call over for questions.

Operator, please read the instructions for the question portion of today's call.

Operator:

Thank you.

Ladies and gentlemen, if you would like to register for a question, simply press the 1 followed by the 4 on your telephone.

You will hear a three-tone prompt to acknowledge your request. If your question has been answered and you would like to withdraw your registration, please press the 1 followed by the 3.

If you are using a speakerphone, we ask that you please lift your handsets before entering your request.

One moment, please, for our first question.

Our first question comes from the line of John Roberts, Buckingham Research.

Please proceed, your line is now open.

John Roberts:

Afternoon Jim.

James Hurlbutt: Hi, John.

John Roberts: Could you talk a little bit about the large order shipped during the quarter for polymers and does that mean the third quarter is going to have a decline in that segment?

James Hurlbutt: That segment will see some decline at least from the polyurethane systems group because that was a non-recurring volume, probably for an annual period. The rest of the business, though, in polymers looks fairly strong for the balance of the year. So, total polymers is still looking at an improvement in the second half.

John Roberts: Could you characterize the nature – or why a year's worth to one customer went in one quarter, or...

James Hurlbutt: It was a ship - it was construction of a ship.

John Roberts: Okay.

James Hurlbutt: They were going to use a polyurethane system foam to fill cavities within the ship and they wanted to install all the foam in a very short window, so we staged all the material to them so they could apply it in a very tight frame of several weeks time.

John Roberts: Right. And then secondly, I don't know if you're willing to comment how big your bio-diesel related sales are today and what the outlook is over - just maybe the near term – the next several quarters. Is it ramping very quickly right now?

James Hurlbutt: Well, because the first quarter - we had been in this business in the past, part of the economics being driven by the Agriculture Department, which had a subsidy for producers of bio-diesel from either soy or ethanol. That economics required you to increase your volumes and, therefore, once you couldn't increase your volumes anymore you were out of the game.

The excise tax credits that have subsequently been enacted create economic opportunity with a longer timeframe. The State of Illinois has got an excise tax credit; the federal government has got an excise tax credit. The hope is that they will extend the federal excise tax credit from the current two-year legislation to an additional five.

That being the case, we have approximately 70 million pounds in capacity and we hope to ship every pound we can produce. Right now our customers are taking every pound we can produce.

John Roberts: And because of the limited window that this opportunity may have, you wouldn't consider adding capacity because you might get stuck with it, I guess, at the end of the program?

James Hurlbutt: We're studying that internally. The big guys, ADM and Cargill have both announced expansions. So, obviously, given the somewhat artificial economics, meaning it's driven by tax credits to make it cheaper than diesel or to put a profit in between straight diesel and bio-diesel, if the tax credits are enacted we would certainly look at the cost of expanding and whether we feel comfortable with the risk-reward ratio.

John Roberts: Okay, got it. Thank you.

Operator: Thank you.

Our next question comes from the line of George Gaspar from Robert W. Baird.

Please proceed, your line is now open.

George Gaspar: Yes, good afternoon again.

James Hurlbutt: Hi, George.

George Gaspar: Question on China, can you give us a little detail now of when you started generating sales and what your capacity is going to be and how do you - how are you going to account for the sales there on a percentage ownership basis? Can you share that with us?

James Hurlbutt: Sure. The plant was dedicated last month. It's up and running, producing product. We've been sampling customers in China. We were running a little tight on capacity in North America, so we actually did place some orders for some material from that Chinese plant. So we're pretty optimistic.

Of course, there's a time lag involved in getting product approvals at existing and prospective customers' plants, so exactly how quickly we will ramp up the volume, is still a little bit of uncertainty. But we didn't (put in) an extremely large plant, it's roughly - I believe it was a 30,000-ton plant with the intention being we're right adjacent to the raw material supplier.

Our partner is the raw material supplier, the phthalic anhydride plant.

So our intention would be, if the market dictates, we'd be able to put in additional reactors, right in line with the one we've already put in.

The percentage ownership is 55% equity ownership in the joint venture, with some benefit to the earning sharing based on our technology being used for the product that - we did go with the majority own situation to - partly just ensure that we would have control over the future of the business.

George Gaspar: Okay.

And in terms of reporting process, then if you control 55%, are you going to be reporting all the sales that are generated within the facility?

James Hurlbutt: Yeah, the only downside to majority ownership is it does require consolidation so we will, you know. All of the plant assets that that will be in our consolidated balance sheet and the income will be in our income statement and then a minority interest will be recorded on the income statement to reflect their share.

George Gaspar: I see. Okay.

And then, you didn't get any sales volume out of there in the second quarter did you?

James Hurlbutt: No.

George Gaspar: Yeah. Okay, so it's going to take a gradual ramp up.

The Brazil situation indicated that, you know, your surfactant volume was up there and I assume that's because it's a facility that you took over, you have contract volumes to deliver, what's the magnitude of your opportunity with the Unilever plant purchase and you know, what kind of volume can you get out of there?

James Hurlbutt: Well - the plant itself today is entirely being used to supply - in addition to acquiring a plant from Unilever on a long-term lease with an option to buy, we acquired the supply contract to Unilever to supply them for the ten-year period.

They will take roughly half of the capacity of that plant. I'm trying to remember the capacity - I think it's in the vicinity of a 100 million pound capacity plant.

So, if they take half, that leaves us half to go use in other markets in Brazil.

What we're looking at though is trying to focus on - not focus - on straight commodities in Brazil, but can we get into the Ag and some of the other specialty markets by adding a reactor to that site.

So, the base business in there is, you know, it's going to make a little bit of money but it's not going to be a significant contributor to overall earnings. But, the next step is we want to get a reactor in there, a multipurpose reactor potentially, that could make a broader array of products.

Quite honestly, we are moving slowly because of the volatility that Brazil people have experienced in investing in Brazil. We want to be very cautious and take some small steps to make sure we are confident in the results we can achieve.

George Gaspar: Right.

And then, any comments on Europe as far as how your polyol margins look in the German facility and then how you size up the UK's situation where competitors now closed the plant, which I assume was done in the second quarter, and does that detail an opportunity right here in the third quarter for you?

James Hurlbutt: We certainly are expecting improvement. We saw a surge in volume in June related to the UK site, as customers really finalized arrangements to get supply from either Stepan, as Huntsman exited the UK market, or made arrangements to be supplied by Huntsman or others from the continent of Europe.

Now, clearly, there is a freight disadvantage but I don't know if anyone in the continent is going to eat some of that freight differential to keep the business, but we see significant improvement coming for the UK.

Now, that being said, we've got a fair amount of room to go to get to an acceptable level of earnings in the UK, but we do believe we've turned the page toward getting back into a profitable operation in the UK by the third quarter results.

It's actually helping our German operation too. I think there's been a little bit of tightening up of supply in the continent, as well, as a result of Huntsman's departure from there, shutting down their plant in the UK.

So, a little bit of tightening in the continent has allowed us to get a little more volume out of our German surfactant plant. And then that, coupled with our polyol operation in Germany, we're covering the overhead of a

bigger operation and we expect that to be profitable as well in the second half.

George Gaspar: Okay.

And then, one on this closing of the Huntsman, what percentage of the market did that represent?

James Hurlbutt: Well, in the UK - I don't have the exact percentage - but a rough number would be, I think we had probably a little more than 50% of the market share and they probably had the majority of the rest.

George Gaspar: I see.

James Hurlbutt: Now, that being said, I caution – they are not leaving the European market. They've shut a plant down in the UK and they're free to compete in the UK with product produced in France and their plants in the continent.

George Gaspar: Okay.

James Hurlbutt: But again, that's not a reliable supply chain and that's why we see a lot of the business moving our direction.

George Gaspar: Okay, thank you.

James Hurlbutt: You're welcome.

Operator: Thank you.

Ladies and gentlemen, as a reminder, to register for a question, please press the 1 followed by the 4.

One moment, please, for the next question.

Our next question comes from the line of Beverly Machtinger, from Grace and White .

Please proceed.

Beverly Machtinger: Hi, Jim.

James Hurlbutt: Hi, Beverly.

Beverly Machtinger: Most of my questions have been answered, but I just have a couple follow-ups on the other questioners.

The UK situation, now that that plant is closed, are you going to try and raise the prices and do you think that you could actually get them through to the customers?

James Hurlbutt: Well, yes absolutely. We have raised prices. We actually were trying to get prices up even before Huntsman announced their shutdown because the raw material situation, increases over the last 18 months, dictated that we had to get our prices up to get our margins back.

This certainly helped and we've gotten margins up in the second quarter and we certainly hope to continue to get the margins up a little more.

Yeah, it's definitely helping.

Beverly Machtinger: And also -- let me think what my other question, oh. The bio-diesel business, where does that stand in the profitability range versus all the other products, that are coming out of those facilities, you're making?

James Hurlbutt: Yeah, it's not as profitable as a specialty chemical, because you're really looking at a commodity chemical. You're simply taking soybean oil and converting it into a fuel by reacting it with methanol and removing the glycerin. So, in large part, it's a commodity, but the margins are pretty good for that type of business today.

For us, it was a low cost, there's no barrier to entry, we had existing equipment easily adaptable to making it and we have the methanol capability in handling equipment already in our plant for other product lines. So, and we already doing glycerin removal and stripping. So, it was a very fairly easy business for us to get into.

The margins will obviously be vulnerable to the fluctuations in crude oil and soybean oil prices. With crude at these prices, there should be plenty of room for margin because you're really sharing your margin between Stepan and the blender who mixes it with diesel and ultimately sells it to the truck stop or fuel distributor.

So today, the margins are good but they are a commodity-type margin.

Beverly Machtinger: Uh-huh. Can you...

James Hurlbutt: The attractiveness though is, you know, we're already up to 70 million pounds and as I said we would certainly entertain, if economically justifiable, a further expansion.

Beverly Machtinger: Okay. And can you give us just some idea, what's happening right now with raw material pricing? I mean, are you getting any kind of sense that you're at the peak and maybe, you know, I mean everybody knows that the crude is just going through the roof, but what sense do you get as far as what's going on out there?

James Hurlbutt: Well, you're putting me on the hotspot, aren't you? I wish I knew.

Six months ago I thought I told you that I thought we had seen the worst. We're seeing things flattening out right now. In the last four weeks, I would say, we're seeing signs that things have at least flattened, even with these near-term gyrations in crude oil.

Part of the difficulty we had last year was not directly crude oil related, there were some alcohol plant shutdowns, outages in Europe, and China was thirsting for diethylene glycol.

So, we see that seems to be back in balance now. There are some alcohol plants going up in China and I believe another part of Southeast Asia.

So, all our gurus tell us that things should start to soften later this year or next year. But, I sure can't predict crude.. I'm so wrong on crude oil, I wouldn't know. We had, our collective judgment including some knowledgeable people in our company, thought we'd be down to \$40 crude by now.

Beverly Machtinger: You and the rest of the world?

James Hurlbutt: We're all wet, aren't we?

Beverly Machtinger: Yeah.

Okay, great, thanks a lot Jim.

James Hurlbutt: Uh-huh. Thanks, Beverly.

Beverly Machtinger: Bye.

Operator: Thank you.

Our next question comes from the line of Steven Weiss, Midflow Capital Investments.

Please proceed your line is now open.

Steven Weiss: Yeah, thank you very much.

Congratulations on a great quarter and improving your profit, Jim, I applaud you.

James Hurlbutt: Thank you.

Steven Weiss: You know, a couple of questions. Regarding commodity prices, obviously crude oil is what it is. A lot of your competitors have been looking at these challenges in the market and putting in some new initiatives to reduce their raw material and commodity prices by opening better lines of communication with their supplier base to, overall, reduce their total landing cost throughout their supply chain, by looking at the supply chain as a whole.

What are you guys doing to improve or reduce your raw material client cost by looking at your supply chain as a whole and, overall, seeing where there's areas of improvement?

James Hurlbutt: Well, we do have a couple of areas where we've been fortunate to have some progress. For example, with our phthalic anhydride business, we sell that now – and have for some time – but it certainly has protected us. We sell that on a price plus ortho. So if the toll fee, or margin, is 5 cents, 6 cents, 7 cents, 8 cents, 9 cents, we sell it at that price plus the cost of the ortho, so we try to neutralize Stepan from the impact of the fluctuations in orthoxylene.

In some of our other businesses, we have done some strategic purchasing. We have an excellent diethylene – long-term diethylene glycol contract that took us through, basically, through last month. So, we had very favorable diethylene glycol pricing for part of – not all of our requirements – part of our contracts – and not all over the world.

So, we have done some of that to try and mitigate as much as we can the volatility in raw material cost.

Steven Weiss: How are you – obviously quality has been real important, I think, as a metric in Stepan's growth over the last 10, 15 years. How do you guys qualify your suppliers to make sure they live up to your standards and provide you with the right raw material commodities when you need them, you can provide those products to your customers.

James Hurlbutt: Well, we have a routine audit from our suppliers and we have certificates of analysis of all products coming in. Quite honestly, the vast majority of

our raw materials come from fairly large chemical producers who, adhere to fairly stringent standards themselves.

So, this has not been a significant issue for us in recent years.

Steven Weiss: Okay. All right, well congratulations on a great quarter and good luck down the road.

James Hurlbutt: Great. Thank you.

Steven Weiss: Thank you.

Operator: Thank you.

Our next question comes from the line of George Gaspar, Robert W. Baird. Please proceed with the follow up question.

George Gaspar: Yes, Jim on your gross margin, your gross profit situation, and looking at overall margins and bottom line, how can you - what can you see in terms of Stepan improving into some historical range? Where do you see yourself and where do you think you can go?

James Hurlbutt: Well, I think I said in the past, our focus is how do we continue to grow the specialty and functional products at as fast a rate as we can and get, capture surfactant margins into higher value added end-use applications.

And a lot of our efforts and lot of our R&D activities are focused on supporting those markets as opposed to, continuing to support commodity margins in laundry and cleaning.

Now, laundry and cleaning is very important to us. We sell a lot of – and enormous array – of products into laundry and cleaning but, we still want to focus on the higher margin products and devote our R&D resources to developing those markets.

George Gaspar: Okay.

James Hurlbutt: I think I've mentioned that we've had some inroads in the emulsion polymerization markets. We've expanded our participation in the agricultural chemical markets.

I mean, surfactants as a laundry detergent is one thing, surfactants for the hundreds of other end use markets is another and we're looking at all those end-use markets.

George Gaspar: Okay. And then, to expand just a little bit on R&D, is there anything in R&D that – on a relatively near term basis – that could come out here and start to contribute to an earnings stream for you – or a revenue stream for you?

James Hurlbutt: Well, as an adjunct to the bio-diesel, we've looked at alternative feedstocks to bio-diesel. Bio-diesel, again, is driven by artificial economics of tax incentives. Could we find a feedstock that would feed bio-diesel as a stand-alone business so it would have economically independent of tax subsidies? We're spending a little time on that.

We continue to pursue flexible foams. As I mentioned, our polymer - our polyol goes primarily into the rigid foam insulation market. The flexible foam market is enormous. We have some sales going into the flexible foam market but a very, very small portion of the market share. And that's furniture foam and automobile seating and that type of flexible foam.

We think we have some performance and cost attributes that are very attractive. You can't say that it's going to be near term. Near term I guess would mean the next couple of quarters, but we do feel it's got some potential in 2006 and beyond.

George Gaspar: Okay. And then your comments – or the company's comments – in the release of the second half and your comments leading into the call. The third quarter has historically been a pretty good quarter for Stepan. Does it suggest that you can duplicate second quarter performance in the third quarter?

James Hurlbutt: We're pretty comfortable that the third quarter is looking pretty good. We typically, certainly for the last four or five years, have seen a fair amount of softness in the fourth quarter, as people slow down their plants and bring their inventories down and shut down, do turnarounds over the holidays.

But the third quarter – we're pretty bullish right now on the third quarter in terms of some of the opportunities we've got going on. The bio-diesel volume should be significantly larger in the second half than the first half, so that gives us some optimism that we have a little better chance of getting through the third and fourth quarter with some solid legs than we've traditionally had, come the fourth quarter.

George Gaspar: Okay. And then a comment on the interim quarter business, is there any chance that the company could maybe change their thought process a little bit and give an interim update from inside the quarter, now and then just to kind of give some guidance as to how the business is going or is the...

James Hurlbutt: Well, we can certainly entertain the thought.

George Gaspar: Yeah. Yeah, I think it would be great if we could hear a little bit more than, you know, it's great to be able to visit on the conference call on a quarterly basis, but I mean if there's – if the company would look at the possibility of issuing a little bit more update on, you know, what you're actually doing and how you're progressing in terms of getting things up and running and what your outlook is, that'd be great.

James Hurlbutt: We will kick it around. I'll get back to you.

George Gaspar: Thank you.

Operator: Thank you.

Mr. Hurlbutt, there seems to be no further questions at this time. I'd like to turn the conference call over back to you. Please continue with your presentation or closing remarks.

James Hurlbutt: I have no closing remarks. I just want to thank everybody for joining us and participating in our call today.

Thank you very much.

Operator: Ladies and gentlemen that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your lines.

Have a great day and thank you again for participating. One moment...

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