STEPAN COMPANY

Moderator: James Hurlbutt
October 19, 2005
1:00 pm CT

Operator: Ladies and gentlemen, thank you for standing by and welcome to the Stepan Company Third Quarter 2005 Earnings Conference Call.

During the following presentation, all participants are will be in a listen-only mode. Afterwards, we will be conducting a question and answer session. At that time, should you have a question, please press the 1 followed by the 4 on your telephone.

As a reminder, this teleconference is being recorded on Wednesday, October 19, 2005.

It is now my pleasure to turn the conference call over to Jim Hurlbutt, Vice-President of Finance.

Please go ahead, sir.

James Hurlbutt: Thank you.

Good afternoon and thank you for joining us.

Before I begin, please note that information in 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 third quarter of 2005 increased 11% to $265.7 million from $238.7 million for the same period in 2004. Higher selling prices, higher sales volume and the effect of foreign currency translation accounted for the increase in sales. Higher selling prices reflect price increases brought on by rising raw material costs, primarily due to the surge in crude oil prices. Sales volume grew by 3%.

Net income increased to $4.2 million or 43 cents per diluted share for the third quarter compared with $1.9 million or 19 cents per diluted share a year ago.

Gross profit improved by 25% to $32.7 million.

Operating income increased 100% to $8.1 million for the third quarter of 2005 from $4 million in the same period in 2004.

There were two noteworthy items included in the current quarter. A gain from fire insurance proceeds resulted in $1.6 million addition to operating income while deferred compensation expense resulted in $1.7 million of expense for the quarter.

Now, I would like to highlight the performance in each of our three segments.

We begin with surfactants, which accounted for approximately 78% of the Company's sales for the third quarter of 2005. Surfactant sales increased 17% from higher selling prices and an increase in volume in North America, primarily due to sales of biodiesel fuel; in Europe, due to volume gains in the United Kingdom; and in Latin America, because of increased sales into the fabric softener market.

Surfactant earnings also improved due to the previously mentioned gain from insurance proceeds related to equipment destroyed by a fire during 2004 at the Company's plant in the United Kingdom.

Sales of biodiesel fuel produced from soybean oil reached 21 million pounds for the quarter versus 3 million pounds in the same period of 2004. The growth in demand was driven by the impact of high crude oil prices on diesel fuel coupled with favorable government tax incentives.

Due to the more favorable economics of biodiesel and growing interest in renewable energy sources, we are expanding our biodiesel capacity from 70 million pounds to a 140-million pound capacity. All of our biodiesel production occurs at our Millsdale plant near Joliet, Illinois, where we are well-situated near soybean and soybean oil production.

Turning to polymers segment, which represented 19% of our revenue for the third quarter of 2005, we saw polymer sales decline by 8% in the third quarter as end user demand in North America for polyol used in roof insulation products slowed in response to high material costs.

Phthalic anhydride earnings improved on slightly lower volumes. Phthalic anhydride margins partially recovered some of the margin lost in prior years.

And finally, specialty products, which accounted for 3% of the Company's third quarter 2005 sales, increased by 22% from higher volume of pharmaceutical ingredients. Some customer requirements were unusually heavy during the third quarter after first half weakness. Fourth quarter specialty volume will not be as strong as the third quarter.

Turning to expenses, the increase in marketing and research expense was largely due to higher salary and pension expenses. While general administrative expenses declined during the third quarter, increased expense in deferred compensation resulted in an 11% increase in overall operating expenses.

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

Regarding our Philippine joint venture, income declined during the third quarter due to an adverse change in product mix. A new fabric softener reactor currently under construction in the Philippines will not benefit earnings until the second half of 2006.

Turning to the balance sheet, total debt at September 30, 2005 was $127.4 million, up from $112.0 million at the end of 2004. Our total debt to total capitalization at quarter end was 42.4%, down from 44.1% at the same time last year.

Capital expenditures were $11.5 million for the third quarter. Year-to-date capital expenditures were $31.3 million. Fourth quarter capital spending should be comparable to the third quarter.

Looking ahead, we expect continued improvement in surfactant earnings. Polymer volume is now expected to remain weak through the first quarter of 2006 as end users delay roof repairs due to the high material costs. High crude oil and natural gas prices have led to increased costs for all of our business segments. However, our price increases have helped to recover these costs. The higher crude oil prices should continue to favorably affect our biodiesel economics for the balance of the year and into 2006.

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: Certainly.

Ladies and gentlemen, if you'd like to register a question at this time, please 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, you may press the 1 followed by the 3.

If you're using a speakerphone today, we kindly ask that you lift your handset before entering your request.

One moment please for the first question.

And that question is from the line of John Roberts with Buckingham Research.

Please proceed with your question.

John Roberts: Good afternoon.

James Hurlbutt: Good afternoon, John.

John Roberts: On the polymer business, one, how can you see so far out into early next year? It seems like an unusually long lead time statement to make.

And then, secondly, with high energy prices, I would have thought insulation would be something people wouldn't be pulling back on.

James Hurlbutt: That's the same question we've been asking our customers. They tell us they don't see a significant improvement until next year. So we're basically relying on our customers' market intelligence.

We were certainly hoping to see it pick back up sooner rather than later hopefully, by the end of this year. A year ago, we saw a pick-up in volume after the hurricanes in Florida. We would expect the hurricane damage in the Gulf Coast to have a favorable impact on roofing volume for next year. How soon that would kick in is apparently, some of the uncertainty in the minds of our customers.

John Roberts: Do they produce in seasonal campaigns so that somehow they've missed a window here on a season and therefore, have to wait until sometime early next year?

James Hurlbutt: You know, I don't think there's that big of an impact driving. I think it's the higher cost of the material that's having a bigger impact rather than the seasonality of the replacement market. But going into winter, they do traditionally see a slowdown. But I think it's going to be some - still take some time before we can see whether there's going to be increased demand resulting from the hurricane damage.

John Roberts: Are there -- is it because there are thin margins at the customer level so they can't absorb price increases without some major increases of their own?

James Hurlbutt: I think it's deferral of -- when the price gets high and the guy is quoting a much higher price to replace his roof, he chooses to defer the replacement a little bit longer…

John Roberts: Okay.

James Hurlbutt: Maybe in anticipation that prices will come back down.

John Roberts: Because you're not selling direct to end customer, you're…

James Hurlbutt: No. No, we sell to the formulator who actually manufactures the insulation foam.

John Roberts: Right.

James Hurlbutt: We're selling him the chemical.

They're expecting demand to pick back up next year. It's just uncertain as to how quickly it's going to pick back up. And certainly, the high energy prices will have a longer term impact because when they go to replace a roof, if they previously had 2 or 3 inches of foam, they may choose to go up to 5 or 6 or more inches of foam and get a payback on their utility savings.

John Roberts: Okay, thank you.

Operator: Our next question is from the line of Beverly Machtinger with Grace & White.

Please proceed with your question.

Beverly Machtinger: Hi, Jim.

I was wondering if you could talk a little bit more about the biodiesel expansion. Obviously, this is, you know, gravy right now, but, and I think, mostly related to tax incentives. But it seems you are making a commitment now to - with this expansion. Can you just talk a little bit more about it? Is this a permanent thing? The capacity of putting on - can that be reversed? What's, you know, just give us a little bit more color here.

James Hurlbutt: Well, the majority of the equipment we've used for the biodiesel is equipment we previously had in service for other product manufacture. So it's a manufacturing process that we use and will continue to use for other products if this market should disappear from us.

We've been very cautious in going into this market because, we well understand that it could turn, go the other way fairly quickly. With minimal investment, we were able to get our plant from 70 million, and the 70 million was based on preexisting assets. Going up to 140 does require another reactor. It will be a multipurpose reactor; so in the event we don't need it for biodiesel production, it will be available for other types of product production.

Yes, there's certainly some uncertainty as to whether this business has a long-term future or not based on government subsidies. But certainly, in the near term, it's something we feel very comfortable taking advantage of. And as we continue to look at expansions, we will be looking at that risk/reward ratio to decide whether it's something we're comfortable with. I think most people know we're traditionally a fairly conservative company. So, I think we'll be pretty cautious on how far we go out on a limb on this.

Beverly Machtinger: So it's really not product demand as much as the subsidy that's driving your interest?

James Hurlbutt: Well, it's the high crude oil prices coupled with the tax incentives that make the net cost of biodiesel cheaper than the straight diesel. So on that basis, there's a fairly decent margin today between the seller of biodiesel and the distributor of biodiesel to put some profit in their pocket. As long as that environment continues, which we now think with the Energy Bill extending the Federal credits through 2008, we feel fairly comfortable that the risk of pursuing this business a little deeper is somewhat cushioned by the fact that the tax credits will be here for at least three more years.

Beverly Machtinger: Right. And can you just give us a little update on what's happening with your China joint venture and the Brazil plant?

James Hurlbutt: Sure.

The China joint venture - the plant is, I previously reported, is up and running smoothly. Product takeaway and conversion of customers is going slower than expected. We've got a lot of customers with sampling product, taking product. Getting them comfortable with using it in their plants has taken more time than we had anticipated.

We think over the next three to six months, we'll have enough product development support in China to get customers converted fairly quickly. But it is going more slowly than we anticipated and will not contribute significantly in 2005.

Brazil - again, we base loaded that with a contract from Unilever. The opportunity, upside opportunity, is really in diversifying the plant we acquired and selling a broader variety of products.

Beverly Machtinger: And…

James Hurlbutt: To that end we've added a reactor -- we're in the process of adding a reactor that will make more than the traditional sulfonic acid product line that that plant produces. We'll be able to get into a variety of products with the first primary focus being on agricultural chem products.

Beverly Machtinger: And when do you see that perhaps coming on line and being a contributor?

James Hurlbutt: Again, probably not until next year.

Beverly Machtinger: Okay, great. Thanks a lot.

James Hurlbutt: Sure, Beverly.

Operator: Ladies and gentlemen, as a reminder, to register a question on today's audio conference, please press the 1 followed by the 4 on your telephone at this time.

Mr. Hurlbutt, there are no further questions at this time. I will turn the conference call back to you. Please continue with your presentation or closing remarks.

James Hurlbutt: I just want to thank everybody for joining us today on this conference call and look forward to talking to you again in the future.

Thank you.

Operator: Ladies and gentlemen, this does conclude today's presentation. We thank you for your participation and ask that you please disconnect your lines.

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