STEPAN CO
Form 10-Q
July 29, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(MARK ONE)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2011

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE TRANSITION PERIOD FROM TO

1-4462

Commission File Number

STEPAN COMPANY

(Exact name of registrant as specified in its charter)

Delaware	**36-1823834**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification Number)**

Edens and Winnetka Road, Northfield, Illinois 60093

(Address of principal executive offices)

Registrant s telephone number (847) 446-7500

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at July 26, 2011**
Common Stock, $1 par value	10,163,317 Shares

Part I **FINANCIAL INFORMATION**

Item 1 Financial Statements

STEPAN COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

Unaudited

(In thousands, except per share amounts)	Three Months Ended June 30 2011	Three Months Ended June 30 2010	Six Months Ended June 30 2011	Six Months Ended June 30 2010
Net Sales	$ 476,989	$ 366,504	$ 899,587	$ 703,534
Cost of Sales	407,404	303,026	768,216	576,504
Gross Profit	69,585	63,478	131,371	127,030
Operating Expenses:				
Marketing	12,171	9,391	23,001	20,342
Administrative	12,680	14,273	23,554	23,336
Research, development and technical services	10,656	10,042	20,887	19,925
	35,507	33,706	67,442	63,603
Operating Income	34,078	29,772	63,929	63,427
Other Income (Expense):				
Interest, net	(2,194)	(1,510)	(4,257)	(2,766)
Loss from equity in joint ventures	(805)	(764)	(1,770)	(1,335)
Other, net (Note 14)	253	(1,111)	565	(1,333)
	(2,746)	(3,385)	(5,462)	(5,434)
Income Before Provision for Income Taxes	31,332	26,387	58,467	57,993
Provision for Income Taxes	10,326	9,318	18,645	20,243
Net Income	21,006	17,069	39,822	37,750
Net Income Attributable to Noncontrolling Interests (Note 3)	(139)	(23)	(194)	(44)
Net Income Attributable to Stepan Company	$ 20,867	$ 17,046	$ 39,628	$ 37,706
Net Income Per Common Share Attributable to Stepan Company (Note 10):				
Basic	$ 2.00	$ 1.66	$ 3.80	$ 3.69
Diluted	$ 1.87	$ 1.53	$ 3.55	$ 3.41
Shares Used to Compute Net Income Per Common Share Attributable to Stepan Company (Note 10):				
Basic	10,345	10,160	10,335	10,130

Diluted	11,178	11,118	11,175	11,052
Dividends Declared Per Common Share	$ 0.26	$ 0.24	$ 0.52	$ 0.48

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.

STEPAN COMPANY

CONDENSED CONSOLIDATED BALANCE SHEETS

Unaudited

(In thousands)	June 30, 2011	December 31, 2010
Assets		
Current Assets:		
Cash and cash equivalents	$ 25,599	$ 111,198
Receivables, net	294,547	199,245
Inventories (Note 7)	159,490	96,552
Deferred income taxes	8,386	8,170
Other current assets	16,570	12,661
Total current assets	504,592	427,826
Property, Plant and Equipment:		
Cost	1,098,279	1,055,553
Accumulated depreciation	(729,513)	(701,968)
Property, plant and equipment, net	368,766	353,585
Goodwill, net (Note 2)	7,289	6,717
Other intangible assets, net (Note 2)	12,636	5,257
Long-term investments (Note 4)	11,518	11,904
Other non-current assets	6,124	6,142
Total assets	$ 910,925	$ 811,431
Liabilities and Stockholders Equity		
Current Liabilities:		
Current maturities of long-term debt (Note 13)	$ 35,809	$ 31,609
Accounts payable	174,577	115,248
Accrued liabilities	52,148	58,770
Total current liabilities	262,534	205,627
Deferred income taxes	9,986	5,154
Long-term debt, less current maturities (Note 13)	154,956	159,963
Other non-current liabilities	82,462	87,616
Commitments and Contingencies (Note 8)		
Stockholders Equity:		
5-1/2% convertible preferred stock, cumulative, voting, without par value; authorized 2,000,000 shares; issued and outstanding 520,089 shares in 2011 and 2010	13,002	13,002
Common stock, $1 par value; authorized 30,000,000 shares; issued 11,595,329 shares in 2011 and 11,511,829 shares in 2010	11,595	11,512
Additional paid-in capital	88,238	83,852
Accumulated other comprehensive loss	(14,127)	(25,599)

Retained earnings	339,820	305,830
Treasury stock, at cost, 1,438,754 shares in 2011 and 1,406,081 shares in 2010	(41,357)	(39,106)
Total Stepan Company stockholders equity	397,171	349,491
Noncontrolling interests (Note 3)	3,816	3,580
Total stockholders equity	400,987	353,071
Total liabilities and stockholders equity	$ 910,925	$ 811,431

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.

STEPAN COMPANY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

Unaudited

(In thousands)	Six Months Ended June 30 2011	Six Months Ended June 30 2010
Cash Flows From Operating Activities		
Net income	$ 39,822	$ 37,750
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	23,007	19,288
Deferred compensation	(709)	929
Realized and unrealized loss (gain) on long-term investments	(438)	367
Stock-based compensation	1,777	1,806
Deferred income taxes	4,846	3,823
Other non-cash items	1,083	1,627
Changes in assets and liabilities:		
Receivables, net	(83,875)	(61,722)
Inventories	(55,088)	(13,745)
Other current assets	(3,586)	(935)
Accounts payable and accrued liabilities	55,151	27,793
Pension liabilities	(895)	(488)
Environmental and legal liabilities	(412)	(847)
Deferred revenues	(890)	(596)
Excess tax benefit from stock options and awards	(1,113)	(2,076)
Net Cash Provided By (Used In) Operating Activities	(21,320)	12,974
Cash Flows From Investing Activities		
Expenditures for property, plant and equipment	(40,400)	(28,007)
Business acquisition	(13,562)	
Sale of mutual funds	1,613	737
Other, net	(2,136)	(1,639)
Net Cash Used In Investing Activities	(54,485)	(28,909)
Cash Flows From Financing Activities		
Revolving debt and bank overdrafts, net	9,738	3,124
Term loan		40,000
Build-to-suit obligation buyout	(12,206)	
Other debt borrowings		440
Other debt repayments	(2,291)	(2,532)
Dividends paid	(5,638)	(5,170)
Company stock repurchased	(1,000)	(3,750)
Stock option exercises	889	3,109
Excess tax benefit from stock options and awards	1,113	2,076
Other, net	(1,265)	(1,273)
Net Cash Provided By (Used In) Financing Activities	(10,660)	36,024
Effect of Exchange Rate Changes on Cash	866	(765)
Net Increase (Decrease) in Cash and Cash Equivalents	(85,599)	19,324
Cash and Cash Equivalents at Beginning of Period	111,198	98,518

Cash and Cash Equivalents at End of Period	$ 25,599	$ 117,842
Supplemental Cash Flow Information		
Cash payments of income taxes, net of refunds	$ 9,832	$ 13,930
Cash payments of interest	$ 4,122	$ 2,778

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.

STEPAN COMPANY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2011

Unaudited

1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The condensed consolidated financial statements included herein have been prepared by Stepan Company (Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations, although management believes that the disclosures are adequate and make the information presented not misleading. In the opinion of management, all adjustments, consisting only of normal recurring accruals, necessary to present fairly the Company s financial position as of June 30, 2011 and its results of operations for the three and six months ended June 30, 2011 and 2010, and cash flows for the six months ended June 30, 2011 and 2010, have been included. These financial statements and related footnotes should be read in conjunction with the financial statements and related footnotes included in the Company s 2010 Form 10-K.

2. ACQUISITION

On June 23, 2011, the Company purchased the Clarinol®, Marinol®, and PinnoThin® product lines of Lipid Nutrition B.V., a part of Loders Croklaan B.V. The acquired product lines will be integrated into the Company s specialty products segment and will be combined with existing Company food and health services products to provide the Company with a unique portfolio of nutritional fats for the global food, supplement and nutrition industries. The acquisition purchase price was $13,562,000 of cash. In addition to the purchase price paid, the Company incurred $0.3 million of acquisition-related costs, including legal and consulting expenses. These costs were reflected in administrative expenses on the Company s statements of income.

The acquisition was accounted for as a business combination and, accordingly, the assets acquired and liabilities assumed as part of the acquisition were measured and recorded at their estimated fair values. The following table summarizes the assets acquired and liabilities assumed:

(Dollars in thousands)	June 23, 2011
Assets:	
Inventory	$ 5,000
Identifiable intangible assets:	
Patents	6,948
Customer lists	736
Trademarks, know-how	429
Total identifiable intangible assets	8,113
Goodwill	483
Total assets acquired	$ 13,596
Current liabilities	$ 34
Net assets acquired	$ 13,562

The acquired goodwill, which relates entirely to the Company s specialty products segment, is deductable for tax purposes. The goodwill reflects the potential manufacturing and marketing synergies arising from combining the new product lines with the Company s existing food and health services products. The weighted average amortization periods for the identifiable intangible assets are as follows: patents- 12 years; customer lists-five years; and trademarks and know-how- five years. The Company continues to evaluate the valuations of the acquired intangible assets, which may result in adjustments to the recorded values of the intangible assets and goodwill.

Due to the timing of the purchase transaction relative to the end of the reporting period, no post-acquisition financial results for the new business were included in the Company s consolidated financial statements for the three and six month periods ended June 30, 2011. Pro forma financial information has not been included because revenues and earnings of the Company s consolidated entity for the three and six month periods ended June 30, 2011 and 2010, would not have been materially different than reported had the acquisition date been January 1, 2010.

3. RECONCILIATIONS OF EQUITY

Below are reconciliations of total equity, Company equity and equity attributable to the noncontrolling interests for the six months ended June 30, 2011 and 2010:

(In thousands)	Total Equity	Stepan Company Equity	Noncontrolling Interests Equity [3]
Balance at January 1, 2011	$ 353,071	$ 349,491	$ 3,580
Net income	39,822	39,628	194
Dividends	(5,638)	(5,638)	
Common stock purchases [1]	(2,274)	(2,274)	
Stock option exercises	889	889	
Defined benefit pension adjustments, net of tax	1,044	1,044	
Translation adjustments	10,081	10,039	42
Derivative instrument gain, net of tax	389	389	
Other [2]	3,603	3,603	
Balance at June 30, 2011	$ 400,987	$ 397,171	$ 3,816

(In thousands)	Total Equity	Stepan Company Equity	Noncontrolling Interests Equity [3]
Balance at January 1, 2010	$ 290,427	$ 289,285	$ 1,142
Net income	37,750	37,706	44
Dividends	(5,170)	(5,170)	
Common stock purchases [1]	(4,807)	(4,807)	
Stock option exercises	3,109	3,109	
Defined benefit pension adjustments, net of tax	756	756	
Translation adjustments	(8,674)	(8,674)	
Other [2]	4,221	4,221	
Balance at June 30, 2010	$ 317,612	$ 316,426	$ 1,186

(1) Includes the value of Company shares purchased in the open market and the value of Company common shares tendered by employees to settle minimum statutory withholding taxes related to the receipt of performance awards.

(2) Primarily comprised of activity related to stock-based compensation, deferred compensation and excess tax benefits.

(3) 2011 includes partners noncontrolling interests in the Company s China and Philippines joint ventures. 2010 includes partners noncontrolling interest in the China joint venture.

4. FINANCIAL INSTRUMENTS

The following are the financial instruments held by the Company at June 30, 2011 and December 31, 2010, and descriptions of the methods and assumptions used to estimate the instruments fair values:

Cash and cash equivalents

Carrying value approximates fair value because of the short maturity of the instruments.

Derivative assets and liabilities

Derivative assets and liabilities relate to the foreign currency exchange contracts discussed in Note 5. Fair value and carrying value are the same because the contracts are recorded at fair value. The fair values of the foreign currency contracts were calculated as the differences between the applicable forward foreign exchange rates at the reporting date and the contracted foreign exchange rates multiplied by the contracted notional amounts. See the table that follows these financial instrument descriptions for the reported fair values of derivative assets and liabilities.

Long-term investments

Long-term investments are the mutual fund assets the Company holds to fund a portion of its deferred compensation liabilities. Fair value and carrying value are the same because the mutual fund assets are recorded at fair value. Fair values for the mutual funds were calculated using the published market price per unit at the reporting date multiplied by the number of units held at the reporting date. See the table that follows these financial instrument descriptions for the reported fair value of long-term investments.

Debt obligations

The Company s primary source of long-term U.S. debt financing is unsecured private placement notes with fixed interest rates and maturities. Certain foreign subsidiaries also carry fixed-rate debt. The fair value of fixed interest rate debt comprises the combined present values of scheduled principal and interest payments for each of the various loans, individually discounted at rates equivalent to those which could be obtained by the Company for new debt issues with durations equal to the average life to maturity of each loan. The discount rates are based on applicable duration funding rates plus market interest rate spreads to borrowers with credit ratings equivalent to those of the Company. The fair values of the Company s fixed-rate debt at June 30, 2011 and December 31, 2010, including current maturities, were estimated to be $123,436,000 and $122,044,000, respectively. The carrying value of the Company s fixed-rate debt was $113,045,000 at June 30, 2011 and $113,359,000 at December 31, 2010.

The Company s Singapore facility also holds fixed-rate debt in the form of a seller note (related to the 2010 purchase of storage tanks), which had an estimated fair value of $14,458,000 at June 30, 2011, compared to a carrying value of $13,843,000. At December 31, 2010, the fair value of the seller note approximated its carrying value of $13,008,000.

Debt at June 30, 2011 also included $25,500,000 for an unsecured term loan that carried a variable interest rate of LIBOR plus a spread of 100 basis points as of June 30, 2011. As of the end of the second quarter, the current market spread over LIBOR for entities with credit ratings similar to the Company s was approximately 200 basis points. Using the current market spread to discount the scheduled principal and interest payment outflows calculated under the contractual spread, the Company estimates the fair value of the variable interest unsecured term loan at June 30, 2011, at approximately $25,018,000 compared to a carrying value of $25,500,000. At December 31, 2010, the fair value of the variable interest unsecured term loan was $26,390,000 compared to a carrying value of $27,000,000.

Also included in debt as of June 30, 2011 was $8,783,000 of term debt of the Company s Philippine subsidiary, comprised of two bank loans guaranteed by the U.S. parent. Using the current market spread for loans to companies with credit ratings similar to the Company s to discount the scheduled principal and interest payment outflows calculated under the contractual spreads, the Company estimates the combined fair value of these variable interest secured term loans at June 30, 2011, to be approximately $9,038,000 versus a carrying value of $8,783,000. At December 31, 2010, the fair value of these term loans was $9,028,000 compared to a carrying value of $8,805,000.

Because of the short-term nature of the remaining Company debt, the fair values for such debt approximate the carrying values.

The following tables present financial assets and liabilities measured at fair value as of June 30, 2011 and December 31, 2010 and the level within the fair value hierarchy in which the fair value measurements fall:

(In thousands)	June 2011	Level 1	Level 2	Level 3
Mutual fund assets	$ 11,518	$ 11,518	$	$
Derivative assets: (1)				
Foreign currency contracts	765		765	
Total assets at fair value	$ 12,283	$ 11,518	$ 765	$
Derivative liabilities: (1)				
Foreign currency contracts	$ 321	$	$ 321	$
Total liabilities at fair value	$ 321	$	$ 321	$

(In thousands)	December 2010	Level 1	Level 2	Level 3
Mutual fund assets	$ 11,904	$ 11,904	$	$
Derivative assets: (1)				
Foreign currency contracts	30		30	
Total assets at fair value	$ 11,934	$ 11,904	$ 30	$
Derivative liabilities: (1)				
Foreign currency contracts	$ 43	$	$ 43	$
Total liabilities at fair value	$ 43	$	$ 43	$

(1) See Note 5 for the balance sheet locations of the derivative assets and liabilities

5. DERIVATIVE INSTRUMENTS

The Company is exposed to certain risks relating to its ongoing business operations. The primary risk managed by the use of derivative instruments is foreign currency exchange risk. The Company holds forward foreign currency exchange contracts that are not designated as any type of accounting hedge as defined by U.S. generally accepted accounting principles (although they are effectively economic hedges). The Company uses these contracts to manage its exposure to exchange rate fluctuations on certain Company subsidiary accounts receivable, accounts payable and other obligation balances that are denominated in currencies other than the entities functional currencies. The forward foreign exchange contracts are recognized on the balance sheet as either an asset or a liability measured at fair value. Gains and losses arising from recording the foreign exchange contracts at fair value are reported in earnings as offsets to the losses and gains reported in earnings arising from the re-measurement of the receivable and payable balances into the applicable functional currencies. At June 30, 2011, and December 31, 2010, the Company had open forward foreign currency exchange contracts, with settlement dates ranging from one month to approximately 30 months, to buy or sell foreign currencies with a U.S. dollar equivalent of $55,982,000 and $25,014,000, respectively.

The Company also holds forward foreign currency exchange contracts that are designated as a cash flow hedge. The Company uses these contracts to manage the risks and related cash flow variability resulting from exposure to exchange rate fluctuations on forecasted progress payments related to a construction project undertaken in Singapore. The progress payments are denominated in a currency other than the Singapore location s functional currency. The latest date through which the Company expects to hedge its exposure to the variability in cash flows for the progress payments is December 31, 2013. The forward foreign exchange contracts are recognized on the balance sheet as either an asset or a liability measured at fair value. Period-to-period changes in the fair value of the hedging instruments are recognized in other comprehensive income, to the extent effective. Once the constructed asset is complete and placed into service, the accumulated gains and losses will be reclassified out of accumulated other comprehensive income (AOCI) into earnings in the periods over which the asset is being depreciated. No reclassifications of gains and losses from AOCI were made into earnings in the three and six month periods ended June 30, 2011. Assuming the construction project is completed on time, less than $10,000 of the amount currently in AOCI is expected to be reclassified into earnings in the next 12 months. At June 30, 2011, the Company had an open forward foreign currency exchange contract designated as a cash flow hedge with a U.S. dollar equivalent amount of $10,268,000. No such contracts were held at December 31, 2010.

The fair values of the derivative instruments held by the Company on June 30, 2011, and December 31, 2010, were as follows:

(In thousands)	Asset Derivatives			Liability Derivatives		
		Fair Value At			Fair Value At	
Derivatives Designated As Hedging Instruments	Balance Sheet Line Item	June 30, 2011	December 31, 2010	Balance Sheet Line Item	June 30, 2011	December 31, 2010
Foreign Exchange Contracts	Receivables, net	$ 106	$	Accounts payable	$	$
Derivatives Not Designated As Hedging Instruments						
Foreign Exchange Contracts	Receivables, net	$ 174	$ 30			
Foreign Exchange Contracts	Other non-current assets	485		Accounts payable	$ 321	$ 43
Total Non-hedging Derivatives		$ 659	$ 30		$ 321	$ 43
Total Derivatives		$ 765	$ 30		$ 321	$ 43