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Certifiably formerly toxic

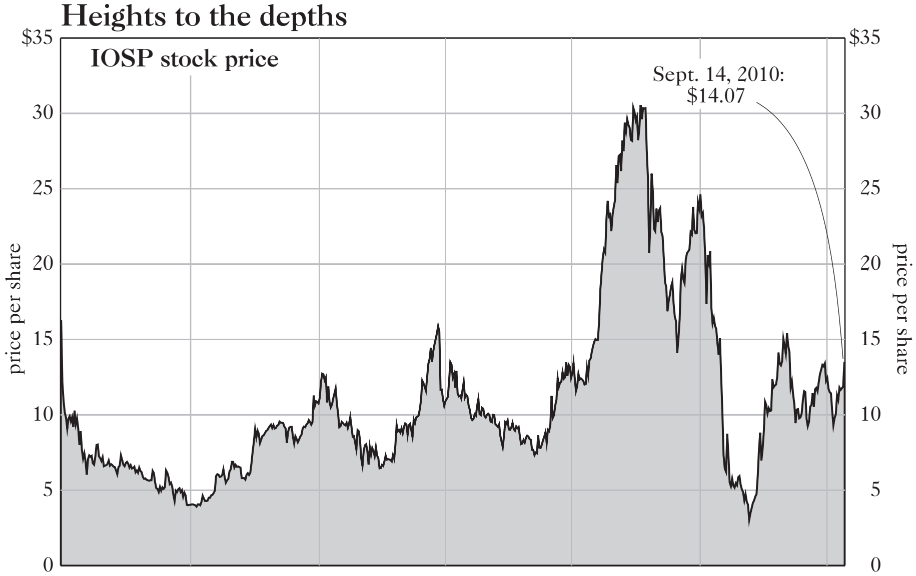
Innospec Inc. is the subject at hand. That is, "[c]orruption-tainted chemical firm Innospec" or "[b]ribery firm Innospec," as a British newspaper has characterized the U.K.-headquartered, Nasdaq-listed maker of a certain toxic compound. These days, a major stockholder seems to want out of his IOSP position, and demand for the company's anti-knock fuel additive used in leaded gasoline since the time of the Model A Ford—TEL, for tetra ethyl lead—is vanishing. And, as if that weren't enough, sell-side coverage is virtually nonexistent. In preview, we're bullish.

We were bullish, too, at the beginning. Begat in a 1998 spin-off from Great Lakes Chemical Corp. (or Chemtura, as Great Lakes was rebranded after the consultants finished with it), Innospec was christened Octel Corp. "Hate the product" was the headline over our bullish review in the issue of *Grant's* dated Dec. 4, 1998. The gist of the analysis was that the new company could generate enough cash to pay down its debt and repurchase its 14 million shares of stock before TEL was regulated out of existence. Little did we know to what lengths management would go to delay the inevitable. Among the crimes to which it confessed in March were those of bribing the Indonesian government, breaking the U.S. embargo of Cuba and paying kickbacks to Saddam Hussein's Iraq under the United Nations Oil-for-Food Program. Back in 1998, we explained away our failure to coax the senior officers to the phone for an interview with a line that today seems not so much lighthearted as air-headed. "As we are bullish," we cheerfully wrote, "we will rationalize this disappointment with the thought that the Octel brass are engaged in no activity except the maximization of shareholder value." Well, yes, in a way.

It's an integral part of the Innospec story that the company's March plea deal with the U.S. and U.K. authorities was accompanied by a management shuffle. Out went the incumbent CEO, Paul Jennings, and in came his successor, Patrick Williams, formerly president of one of the company's non-TEL divisions (and uninvolved with the extracurricular marketing activities, it appears).

That the non-TEL businesses are coming on strong is another integral part of the Innospec story. The largest of the company's three operating divisions makes non-TEL chemical additives to mix into fuels to boost engine performance and reduce exhaust emissions; over the past 12 months, it accounted for 67% of sales and 71% of gross profit. Until 2004, growth in the additives group had come mainly from acquisitions. Since then, however, 43% of its sales have derived from homegrown products. Competitors "can't produce our products," CEO Williams tells *Grant's*. And he adds: "This is an incestuous business. A lot of our competitors buy products from us either because of patents or our scale." The

Heights to the depths



source: The Bloomberg

business, Williams explains, is broadly driven by "legislation and engine technology." With disruption from either source, refiners must buy new additives to meet new specifications. Nelson Christian, manager at CountryMark, an independent oil refiner in Indianapolis, tells our scout that the rising price of additives tops his list of business worries. "I don't know how many competitors there are today compared to five years ago," Christian says, "but it feels like there are fewer due to mergers and acquisitions."

Innospec's Active Chemicals division (22% of sales and 15% of gross profit over the past 12 months) had been the corporate problem child. As recently as 2008, it was showing $5 million a year in losses; over the last 12 months, it has delivered $12.5 million in operating profit. Surfactants are its principal stock-in-trade. As every former chemistry student remembers, surfactants are compounds that, by lowering the surface tension of water, may act as a detergent, emulsifier or foaming agent—one that, for instance, puts the bubbles in shampoo. The company's new Cadillac product, a surfactant called Iselux, contains none of the carcinogens that commonly turn up in the alternative brands; customers seem not to miss the 1,4-dioxane and sulfates at all.

As for Innospec's legacy TEL business, it chipped in 10% of sales and 14% of gross profit over the past 12 months, as the company has the market all to itself. Even adjusting for non-cash goodwill write-downs and legal expenses, there's money in it yet. That it's shrinking all can see. When it might disappear is another question. "Four years ago," Williams tells *Grant's*, "we would have thought we would have exited this business by 2011. TEL does what it does. It hits the octane needed in aviation. I don't think that will go away until 2020 at a guess. Mogas [motor gasoline]—we thought we would be out by 2010, but that business will last another four to five years."

"Although the financial magnitude of this settlement is significant," Williams said at the time of the company's March plea bargain, "our ability to deliver on Innospec's long-term business strategy remains strong and I look forward to the future with great optimism." The exact financial magnitude—$40.2 million in fines, penalties and disgorgement of profits, payable over four years—may have seemed steep to the stockholders (it was greater than operating income in two of the past four years), but it left at least one British jurist muttering that the company got off scot-free. Be that as it may, Innospec reserved for the full amount in the third and fourth quarters of 2009.

With the lifting of that particular concern, another remains, and Tontine is its name. According to a 13D filing in November 2008, Jeffrey Gendell, general partner and founder of Tontine Associates, a Greenwich, Conn., hedge fund, had accumulated 20.5% of IOSP's shares (a suitable marriage of fund and investee, it seems, as the TEL market was a kind of tontine, with Innospec having outlived all the other competitors to become the sole producer). Owing to losses suffered in 2008, however, Gendell was obliged to liquidate his positions, including the chunky one in IOSP. As of his latest filing, on Sept. 10, Gendell had reduced his holdings to 14.4%, or 3.4 million shares. That he may have to sell them all is the invisible hammer over the share price. (A spokesman for the fund declined to comment.)

So much the better, we say on behalf of that rare and hardy breed, the low-frequency trader. On the face of things, Innospec may not look like a bargain at 21.6 times earnings and at a ratio of enterprise value to EBIT (earnings before interest and taxes) of 12.6. But that is where the valuation story begins, not where it ends. In the past 12 months, Innospec generated $35 million, or $1.38 a share, in earnings before interest and taxes. And that was after reserving for that $40.2 million in settlement charges and $8.2 million in non-cash charges to convert the corporate pension plan from defined benefit to defined contribution. Abstracting from those two items alone, the shares would trade for 5.2 times EV to EBIT.

Inside Innospec
(in $ millions, except per-share data)

	12 mos. to 6/30/10	2009	2008	2007	2006
Net sales					
Fuel specialties	$434	$423	$441	$375	$311
Active chemicals	145	130	138	134	120
Octane additives	67	46	61	94	100
Total	645	599	641	602	532
Gross profit					
Fuel specialties	145	147	146	125	106
Active chemicals	31	27	13	25	23
Octane additives	29	15	28	48	58
Total	205	189	186	197	187
Operating income					
Fuel specialties	79	81	80	64	46
Active chemicals	13	9	(5)	6	6
Octane additives	(17)	(45)	1	20	35
Pension charge	(9)	(6)	(2)	(5)	0
Corporate costs	(21)	(13)	(25)	(22)	(22)
Restructuring	(10)	(3)	(2)	(3)	(5)
Impairment	(2)	(2)	(4)	(12)	(37)
Profit on disposal	0	0	0	0	9
Total operating income	33	21	44	48	32
Other income	(1)	4	(19)	7	7
Net interest expense	(5)	(6)	(5)	(7)	(7)
Profit before tax	27	18	19	48	32
Taxes	11	12	6	18	20
Net income	16	6	13	30	11
EPS	$0.65	$0.26	$0.51	$1.19	$0.90

On the basis of price to free cash flow, IOSP, at 6.2 times, is considerably cheaper than the companies to which it may be fairly compared.

To hear management talk, it's determined to bring itself and its stock out of the shadows. On the second-quarter call, Williams said that the company will "step up our investor relations program significantly in the second half" and that it has "begun looking aggressively at a variety of strategic alliances and acquisition opportunities." As the company had once paid a dividend and repurchased stock, Williams indicated that such share-price-enhancing stratagems are back on the table again. Asked to elaborate, Ian Cleminson, the CFO, tells *Grant's*, "We want a balanced capital management program. We are willing to put our dollars into acquisitions, dividends and buybacks. Most important to us is organic growth. We will invest in Iselux. We will invest in acquisitions as well. If the time is right, we will do a buyback. We will do that on a contained basis. A dividend is probably further down the line given tax changes in the U.S." Elaborating in turn, Williams adds, "We've looked at four deals in the last four months but multiples are outrageous. I'd rather buy back my stock than overpay for a business."

Innospec vs. the field

company	ticker	EV/ sales	EV/ EBITDA	EV/ EBIT	P/E	P/FCF	P/B
Innospec Inc.	IOSP	0.7x	7.8x	12.6x	21.6x	6.2x	1.9x
Fuel specialties							
Lubrizol Corp.	LZ	1.4	5.8	5.5	10.4	10.8	3.2
NewMarket Corp.	NEU	1.0	5.1	4.9	8.5	21.3	3.4
Albemarle Corp.	ALB	2.0	10.3	12.6	14.7	12.3	3.2
Avg.		1.5	7.1	7.7	11.2	14.8	3.3
Active chemicals							
Givaudan S.A.	GIVN VX	2.6	12.7	18.4	27.7	23.8	2.5
Int'l Flavors & Fragrances	IFF	1.8	9.5	10.5	14.9	15.0	4.4
Stepan Co.	SCL	0.5	3.9	6.6	9.4	12.1	1.9
Avg.		1.6	8.7	11.8	17.3	17.0	2.9

sources: The Bloomberg and company reports

In our conversation with Williams, we asked if the company is for sale. "We want to do what is best for our shareholders," the CEO replied, "but we feel comfortable with our strategy. We think we will get greater value by executing our strategy in the next three to five years than being bought out in the next 12 months." "We are undervalued," Cleminson added. "If someone came in right now, it would be a bid off a low base."

Deeds underscore words in this regard. In 2010, the insiders (hedge-fund manager Gendell excluded) have sold no shares but have laid out $613,777—in cash, no less—to buy them.

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