

November 7, 2017

Phibro Animal Health Corporation (PAHC)

Q1 September 2017 Earnings Call



CORPORATE PARTICIPANTS

Jack Bendheim Phibro Animal Health Corporation - Chairman, President & CEO

Richard Johnson Phibro Animal Health Corporation - CFO

CONFERENCE CALL PARTICIPANTS

David Reed Risinger Morgan Stanley, Research Division - MD in Equity Research and United States Pharmaceuticals Analyst

Michael Leonidovich Ryskin BofA Merrill Lynch, Research Division - Associate

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Phibro First Quarter Financial Results Conference Call. As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host, Richard Johnson, Chief Financial Officer.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Thank you, operator. Good morning, everyone. Welcome to the Phibro Animal Health Earnings Call for our First Quarter ended September 2017. On the call today are Jack Bendheim, our Chief Executive Officer; and myself, Richard Johnson, Chief Financial Officer. We'll provide an overview of our quarterly results and then we'll open the lines for your questions.

Before we begin, let me remind you the earnings press release and financial tables can be found on the Investors section of our website at pahc.com. We're also providing a simultaneous webcast for this morning's call, which can be accessed on the website as well. Today's presentation slides and a replay and transcript of the call will also be available on the website later today.

Our remarks today will include forward-looking statements, and actual results could differ materially from those projections. For a list and description of certain factors that could cause results to differ, I refer you to the forward-looking statements in our earnings press release.

Our remarks today will also include references to certain financial measures, which were not prepared in accordance with generally accepted accounting principles or U.S. GAAP. I refer you to the non-GAAP financial information section on our earnings press release for a discussion of these measures. Reconciliations of these non-GAAP financial measures to the most directly comparable U.S. GAAP measures are included in the financial tables that accompany the earnings press release.

And so with that out of the way, here's Jack for some introductory comments.

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

Thank you, Dick, and thank you, everyone, taking the time to join us this morning. We had a very strong performance this past quarter, our Nutritional Specialties sales were up 17%, and sales of vaccines were up 25%. This tremendous growth is a direct result of our efforts to work with our customers, especially those in the United States, who have moved to eliminate or limit the use of medically important antimicrobials. This growth more than made up the sales decline in MFAs and other, which we had expected, as we overlap with last year's quarter. We expect one more quarter of negative overlap in U.S. sales of medically important antimicrobials.



This quarter was also marked by improved economic conditions in Brazil, a key market for us. Current indications are that this economic rebound is sustaining and we continue to see the cattle market in Brazil and globally as a key focus for our continued growth. We see cattle as an attractive species for sales and growth across all of our Animal Health segments. It was with this in mind we acquired the Biotay business as we look to leverage Biotay's well-respected presence in the Argentine cattle sector.

We see many opportunities to strengthen our internal product development and organization capabilities as we fully capitalize on our existing portfolio, our pipeline and adjacent opportunities. It's my belief that we are only just scratching the surface of these internal growth initiatives. As we noted in our guidance for the year, we have increased operating expenses for developing the opportunities. While the results of the increased spending may not be apparent this fiscal year, it will pave the way for above market growth in the years to come. We continue to be active on the business development front particularly where we can use synergies from our product portfolio and/or our organization to drive profitable growth.

I will now turn it back to Dick and look forward to our discussion after our prepared remarks.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Thanks, Jack. Before we get into the numbers, I'd like to remind everyone that we do present our results on a GAAP basis and also on an adjusted basis. The adjusted results exclude all acquisition-related items, such things as intangible amortization, inventory step-up, accrued compensation costs, transaction costs and accrued interest. We also adjust and exclude unusual, non-operating or nonrecurring items, some other income and expense items that would include foreign currency, gains and losses that are reported separately in our financials. And also the income tax effects relating to each of those pretax adjustments plus any unusual or nonrecurring income tax items themselves.

So with that, let's turn to Page 5 and review the highlights of our September quarter. Our consolidated sales were \$193 million for the quarter, a 3% increase versus the same quarter last year. The increase was driven by volume growth in the Animal Health segment and by commodity pricing in the Mineral Nutrition segment. We reported net income of almost \$16 million and diluted EPS on a GAAP basis, which we improved substantially from the prior year.

Our sales and gross profit improved over last year and offset increased investments in operating expenses. In addition to the sales and operational increases, our reported results benefited from several other factors, including we had reduced acquisition-related transaction costs in the current quarter; we reported reduced net interest expense due to lower financing or borrowing rates from our new credit facilities that we've recently entered into; and our provision for income taxes. The effective tax rate was favorable due to the benefit of both employee stock option exercises and a favorable mix of international income.

On an adjusted basis, adjusted EBITDA was \$30.1 million, up \$300,000 or 1% over last year, and we'll discuss that in more detail as we discuss segment performance in the coming slides. Adjusted diluted EPS was \$0.38 a share. That was a \$0.02 per share or 6% increase over last year. Adjusted EBITDA-- the improved adjusted EBITDA was offset by increased depreciation expense, but adjusted net income and adjusted diluted EPS benefited from the lower net interest expense and a lower effective income tax rate due to that mix of international income.

On Page 6, these are the selected line items from the P&L. And as we -- I'll just skip past the sales growth because we'll handle that in more detail when we look at the segments. But in total, adjusted gross profit increased \$2.6 million or 4% due to the volume growth in the sales increase also due to favorable product mix and due to certain production efficiencies, manufacturing cost-savings, basically.

Adjusted SG&A increased \$2.7 million in total, roughly the same amount as the increase in gross profit. And that was due, primarily due to increased spending in the Animal Health segment. To position ourselves for future growth, we've increased spending on product development and organizational capabilities as we called out in our expectations in our guidance for the year.

Our adjusted net interest expense was favorable as I said on the improved borrowing rates and adjusted income taxes, favorable due to the mix of international income.



So looking at Page 7 and looking more closely at Animal Health. Sales were almost \$129 million that was growth of \$4.3 million or 3% over last year. The sales growth was driven by strong increases in the Nutritional Specialties and Vaccine product groups, offset by a decline as we expected in the MFA and other category.

Nutritional specialty products were almost \$31 million in the quarter. That category grew \$4.5 million or 17% over last year on volume growth in the products for the U.S. poultry and dairy industries. Vaccine sales were \$18.5 million for the quarter, and those sales grew \$3.7 million or 25% over last year on volume growth across the product portfolio.

Looking at sales of MFAs and other. Those sales were just under \$80 million in the quarter, a \$3.8 million or 5% decrease from last year. Looking at that between the U.S. and international. Our U.S. sales of MFAs and others declined \$10.5 million. Of that decline, \$4.2 million of the decline was due to reduced sales of medically important antimicrobials, primarily on the change in consumer preferences and the lower use of certain antimicrobials in the market. It was also due to unfavorable timing of certain customer orders.

Internationally, our sales of MFAs and others increased \$6.7 million due to growth across most of our regions, and including the benefit of improved economic conditions in Brazil.

Our gross profit, calculated on an adjusted EBITDA basis for the segment, gross profit for the segment increased \$3.7 million on the volume growth, favorable product mix and production efficiencies. Within the segment, we increased our operating expense spending by \$2.5 million, as I said for increased product development costs and improvements in our organizational capabilities. And that all lead to adjusted EBITDA of \$33.7 million, which was an increase of \$1.1 million or 3% and due to the sales growth and favorable gross profit, partially offset by the investments we made in operating expenses.

And now looking at the other segments on Page 8. Mineral Nutrition net sales of approximately \$52 million, increased \$500,000 or 1% over last year, primarily due to commodity pricing. Segment -- adjusted EBITDA of the \$3.7 million was down \$300,000 from the prior year on higher raw material costs. Performance product net sales of \$12.5 million were a bit ahead last year but adjusted EBITDA declined on higher product costs, and corporate expenses were approximately even with last year.

Looking briefly at our balance sheet and capitalization and capital allocation. On a gross basis, our leverage ratio of debt to adjusted EBITDA was 2.8x at September. We had \$62 million of cash on hand at that point in time, so that was roughly half a turn of leverage, so on a net basis, our leverage -- our net leverage ratio would be about 2.3x.

For the quarter, net cash flow before business acquisitions and financing was approximately breakeven. We saw ordinary course use of cash from the timing of sales and collections in our accounts receivables. We also saw use of cash from the routine timing of payments of annual incentive compensation.

We invested approximately \$12 million in the business acquisition on the quarter. We acquired an Argentine Animal Health business as a platform for growth in the Argentina beef sector. And we paid a quarterly -- the routine quarterly dividend in the quarter and declared the same amount to be paid in late December.

And then lastly, we have reaffirmed our annual guidance and have presented it here in the webcast presentation for ease of reference, no need to talk through it again, so no changes to the numbers -- we've reaffirmed what we put out a couple of months ago.

So that's the conclusion of our prepared remarks. So operator, if you would open the line for questions, please.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Derik De Bruin from Bank of America.

Michael Leonidovich Ryskin - BofA Merrill Lynch, Research Division - Associate

It's actually Mike here on for Derik. I just wanted to touch on a couple of quick points. You mentioned some of the impact in MFA and other segments in the U.S. would be due to unfavorable timing in purchase orders from customers. And are you expecting to make some of that up in the second quarter, second half, or is that tied more from the comps from prior year' results?

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

It's more -- it's forward -- we'll see the offset going forward. So Q2 or the remainder of our fiscal year. We'll start to see business come back. We've seen will continue to the fourth quarter as you've noted and as everyone's noted, with a consumer preferences, at the use of antibiotic in general and medically important antibiotics has come down to a level, which we think is sustainable. We'll see that going in the first quarter of '18.

Michael Leonidovich Ryskin - BofA Merrill Lynch, Research Division - Associate

I just want to follow up with the Biotay acquisition. You talked about its strength in Argentina, South America, and particularly in the cattle segments. I wonder if you could talk a little bit what type of products, is it antibacterial or MFAs or more nutritional specialties in any opportunity to move that or expand that in the U.S. on those lines?

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

We try to run our business around the world and be in places that have the ability to raise lots of growth -- animal growth. Argentina is the third or fourth largest producer of cattle in the world. They've gone through some political turmoil the last couple of years, now clearly stable again and it's a market where we had a small office. We were doing some business but we wanted to increase our presence in the cattle market and look to sell there, it's a whole range of products and products are going around the world. What we're doing in Mexico and Brazil and Australia, et cetera, et cetera. So these people have a range of products. We are going to look to have something unique that we can take elsewhere, but our focus is going to be bringing on Nutritional Specialties and Vaccines and some of our antibiotics to that market to help them maximize efficiency and produce healthy animals and help them gain their exports around the world.

Michael Leonidovich Ryskin - BofA Merrill Lynch, Research Division - Associate

If I could squeeze in 1 last one on the SG&A bump. Is the focus there in terms of innovation still in the vaccines and nutritional specialties businesses, and they, you mentioned some work on organizational sales force, is that primarily in the U.S. or overseas in particular area focusing on?

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

So I think it's a yes, yes and a yes. We are increasing our efforts in Nutritional Specialties and Vaccines, both in the U.S. and around the world. So as we hire more sales people and tech people around the world, we need more back office so it is both headquarters, it is both in region and focus is on these new products we've been very successful in launching in the states and we get those across the world.



Operator

Your next question comes from the line of David Risinger of Morgan Stanley.

David Reed Risinger - Morgan Stanley, Research Division - MD in Equity Research and United States Pharmaceuticals Analyst

Jack and Dick, congrats on the results. I would like to ask any color you may provide in the December quarter just so that we understand, you mentioned the MFA comment earlier, but any other anomalies we should think about either year-over-year or sequentially when we're forecasting the December quarter? And then, Jack, if you could just add anymore perspective on ex-U.S. positives or negatives. Obviously, it's very hard for us as investors in the U.S. to understand what's happening in Brazil or what's happening in some of the other markets you serve globally. So if you could just discuss some pushes and pulls with respect to the outlook for your business in ex-U.S. markets. That will be helpful.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

So let me take the first part, Q2 and looking forward. I would frame that as we've reaffirmed our guidance for the year. Our initial guidance said that the first half of our year would be on an EBITDA basis, roughly flat with the prior year. That's what we saw in our September quarter and we've stayed with that same guidance. We haven't updated that guidance. I think as you mentioned, we talked about the overlap on the U.S. decline of medically important antimicrobials, and we are -- continue to expect over the course of our fiscal year, sales and EBITDA growth in line with our guidance.

Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

And Dave, it's a very good question. So we take it in two parts. 1, in terms of our business, we see growth around the world in cattle. So as Brazil returns, we'll benefit from that. We continue to have good presence in Southeast Asia, in Africa, and South America and sort of kind of looking gain a little bit in North America. Overall though, I just came back couple of weeks ago from China, health animals organization that met in China and it's sort of what we saw there and what he heard in the past, represent what's going around the world. The Gates Foundation, for example, spending a lot of money with the WHO, because it's not just about human health, it's human health tied to Animal Health. As population growth, and people try to grow out of poverty, their need and ability to get food, which is nutritious and healthy, proteins, which is available and very, very important to feeding the population the world and increasing human health around the world. So Gates is putting billions of dollars into this, and we see this or other will pick so we see a very, very rapid movement to what we have grown to expect in the United States now for 50, 60 years. And countries around the world have the benefit of not going to the feed on here or the Europeans have done. They're going right away to first line forms of feeding animals, of taking care of animals. So we're seeing rapid growth in population in the protein business, which predominantly is poultry. In China, we seen a rapid change in, not the consumption, but in the quality of the pork, in which means, causing smaller farms to close, because they don't necessarily know how to take care and keep the animals healthy, into moving to larger farms. And we see that happening very, very rapidly now in China. So all of these effects, whether it's in Africa or Southeast Asia or in China or in South America, will impact all of our business, not just Phibro, but all of the people in the sector because we have the technology, we have the expertise, we have the people and we have the reach. So it comes back to what I said earlier, I'm very, very optimistic about growth for us as well as our competition - but more about us - as we take advantage of these changes around the world.

Operator

All right. I'm showing no further questions at this time. I'd now like to turn the call back over to Richard Johnson.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

All right. Well, we'll say thank you to everyone, and have a Happy Thanksgiving. We don't have any cooking suggestions for this year.



Jack Clifford Bendheim - Phibro Animal Health Corporation - Chairman, President & CEO

I bought a new fryer. The last fryer I had some electric problems up and now I have a slightly different one. I will report how I do with my turkey.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

All right, everyone. Have a good day, be good talking. Thanks. Bye.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may now disconnect.

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