

Phibro Animal Health Corp

**May 16, 2018
12:20 PM EDT**

Mike Ryskin: My name is Mike Ryskin, I'm on the Life Science Tools and Diagnostics Team. We also cover animal health and CROs, so all the miscellaneous fun things. Joining us today is Mr. Richard Johnson from Phibro Animal Health. Thank you for coming out, and before we get started, just the selfless plug: II season is upon us, if you could put in a vote for the Life Science Tools team, under Derick de Bruin, or just under the broader Bank of America, we'd greatly appreciate it.

So, let's get started. Congrats on recent performance. The last couple quarters have been a dramatic improvement, I think above our expectations, and probably above your initial expectations as well. Can you give us a quick overview of what's gone right in the last couple quarters, what's really turned around for the business, where's the growth coming from?

Richard Johnson: Sure. Before I start, Jack Bendheim, our Chief Executive Officer, also planned to be here today but a family matter kept him away, so Jack sends his regards and regrets, and looks forward to talking at some future point. He'll be back in the office in a few days.

So, I think our business is growing nicely. We had good Q3 growth, what was it, 10% top-line sales growth, and nice EBITDA growth. And it's growing really across almost all of the markets that we serve, where we're in most of the major animal production markets in the western hemisphere, Canada, United States, Mexico, down through Brazil, Argentina, some of the other South America countries. We're in selected Asia markets, we sell into China and other markets in that region. We're in Eastern Europe, and down through some of the Middle Eastern countries, and a couple of select African countries. So, we saw good growth internationally and we saw decent growth in our domestic business in the quarter, and that's really confirmed our expectations. I'd say our March quarter was in line with the revised guidance we put out in the middle of our fiscal year. We just affirmed or did not modify that guidance with our March results, so still on track, we believe, to be somewhere in those guidance ranges as we get to the end of our fiscal year, which is a June year-end.

Mike Ryskin: Yep, and then that's a good starting point. So, leading off from that, obviously the exposure, one of the big overhangs on the stock over the last couple years has been the exposure to MFAs and specifically medically-important antibacterials or MIAs in the United States. It's sort of dampened the performance of the company in prior years, but this fiscal year a really strong rebound, and even in the US you mentioned that in this last fiscal quarter the performance was flat. So, can you give us an update on that particular

business segment? Does this mean that all the headwinds are behind us, and that it can return to growth in the US going forward?

Richard Johnson: Yeah, we've talked about it. I mean, clearly there's pressure. It's primarily consumer-driven pressure to reduce or eliminate the use of certain antibiotics, in animal production and primarily in poultry production, although it's across most species. And we've -- we have disclosed what those numbers were. Maybe three years ago that number was close to \$40 million. Today, I think, on a trailing basis it was \$16 million or \$17 million at the end of March. So, we've seen that piece of our business decline over time. We have seen other products that are not in that same focus area and especially what we call nutritional specialty products, these are lightly-regulated, some combination of natural plant-based ingredients. We have been able to launch some products that have been, while not direct substitutes, helped the producer control the health problems and pressures that he's still seeing, as he takes away some of the more traditional tools from his ability to raise those animals.

So, we've been saying -- we said, I think, the last couple of quarters, that we believe that in the US, what are called "medically-important" antimicrobials, that's stabilized. And so, it's at that mid-teens level. Could there be a little more bumpiness, but there's not a lot more decline, there. So, we're seeing a growth in other products, and as a result, we're seeing our domestic business overall growing nicely.

Mike Ryskin: All right, and staying with those MIAs, just to finish up on that, that's primarily three product lines for you that you called out including Virginiamycin. Is there any risk from either a regulatory perspective, or from the consumer perspective, where that expands in the US to cover other products with MFAs, or is that really as you said, is the rest of the portfolio really sort of secure and safe from that?

Richard Johnson: I don't believe there's any, with the rest of our portfolio in the US, there's no -- there's neither regulatory nor consumer-driven pressure on other products in our portfolio in the US, no. It's really concentrated on that small group of products.

Mike Ryskin: And this has been an issue primarily in Europe and the US. In Europe, it was, if anything it would have been ahead of the US, starting in the late 90s and really peaked in the 2000s. The US was the last couple years. Can you talk about what the market environment is for these products in Asia and Latin America, because you have a strong presence there?

Richard Johnson: The whole world pays attention to what the developed markets like the US and Europe do. So, certainly the rest of the world is aware of this movement to reduce or eliminate certain antibiotics. I think it comes down to really efficiency and cost of production, and you really have to balance the ability to produce healthy, affordable protein versus taking away tools that increase your cost of production. And so, the focus, in many markets around the world, is much more on affordable protein versus having a label that says, "no this, no that, no the other thing."

Mike Ryskin: Got it. And then, staying in animal health but moving to some of the other segments, you talked about the growth drivers in nutritional specialties and vaccines. Those have really been phenomenal growth for you in the last couple years, 20% growth. In recent quarters, especially vaccines, has moderated somewhat. Part of that is the tough comps, but is there anything else going on there, and could you give us an overview of what particular products are driving the growth in these segments and some of the geographic mix? Is this really US and Europe, or is there opportunity in APAC and LatAm as well?

- Richard Johnson: Sure. Yeah, we've been -- our animal health segment, which is a little over \$500 million today, \$525 million thereabouts, we have almost \$200 million now between those two categories of nutritional specialties and vaccines. So, we are more and more balancing our portfolio, and while we continue to grow the traditional medicated feed additives, as Mike said, we've grown much faster, something around 20% over the last four or five years on an annual basis. We've grown these nutritional specialties and vaccines.
- Growth has been -- because they're smaller categories, quarter-in, quarter-out, disease pressure, customer order patterns, etc., you may get some variation. I think we see a long runway yet for additional growth and penetration.
- On the nutritional specialty side of our business, all of those products have started and the bulk of that portfolio even today is domestically-focused. So, we think there's a lot more penetration opportunity in the US. We think there's a lot of opportunity to take those products to other international markets. And, then, we think there's other, quite a bit of opportunity to add to the portfolio by bringing in other interesting technologies and bringing those to market and growing them.
- Similar thing on vaccines; vaccines are for us, poultry- and swine-focused. They're a mix of probably two-thirds of that business is international, maybe a third of it is in the United States, and there the -- your products and your sales are more dependent on the specific short-term disease situation. So, we've called out this year that our U.S. business has been slow because we just haven't seen the disease outbreaks that our particular products are most effective against. So, that happens. It comes, it goes.
- Mike Ryskin: And then sticking with primarily the -- I want to stick with the livestock for now before we move on to some of the newer focus areas -- how do you approach the market with all the animal health products? Between the MFAs, the nutritional specialties and vaccines, both domestically and internationally, it's the same sales force. What's the conversation with the customer like, and what are the synergies between the different areas? Does that allow you to transition people from your MFAs and MIAs that are under pressure, to the newer products?
- Richard Johnson: Yeah, well you know, our sales forces are aligned by the way our customer does business. So, it's essentially, we'll have a poultry sales force in a market, we'll have a swine sales force, we'll have a beef sales force. Some customers overlap and will produce multiple operations, but even if it's a big customer, it's producing two or three different kinds of protein, they internally specialize in -- because the challenges are different. So, our salespeople who are generally quite highly trained and technically qualified -- they're nutritionists, they're vets, they're good long experience in the industry -- they have the ability to go in and sell the entire portfolio. So, we're not selling on -- we're selling the way the customer thinks about their business, and was that your question, Mike?
- Mike Ryskin: Yeah, yeah. Yeah.
- Richard Johnson: Okay.
- Mike Ryskin: And when we -- I mean, from the very first conversation we had with you, when we were starting to pick you up, a point of emphasis was that you want to be species-agnostic, product-agnostic, provide whatever you can to help the livestock producer, the rancher, to grow healthy animals. Are there any gaps in the portfolio that you can identify today, either by species or product type, or specific disease, where you think there's opportunities? I mean, you have a relatively high exposure to poultry, so maybe is there a stronger presence in cattle that you could pursue, or --?

Richard Johnson: We've called out recently that we've had ongoing success and a nice part of our overall growth has been the expansion into the cattle sector, mostly in international markets. And so, sure, there's always more products. I think we -- in terms of a product focus, we are looking to add additional nutritional specialty products, we're looking to add additional vaccines. The medicated feed additive universe is largely fixed, and there's not really any innovation there to speak of. So, we'll be looking to innovate, and add business, add products in those other categories.

Mike Ryskin: And while we're on the topic, you mentioned cattle internationally. You had a nice acquisition in Argentina last year. Can you talk about some of the -- it's been six, nine months now, has that helped you build up scale in that end market? And that geography? And are there further opportunities for little bolt-on deals, to target specific areas like that?

Richard Johnson: It's early days, so it -- we are very optimistic. The integration has gone nicely. When we look at these smaller bolt-on acquisitions, I'd say we look at -- we look at either one of two areas. We either look to a product or a product line that is underserved, under-represented in the market, where we can take a good set of products, put it into our sales organization and drive the growth of the products. We've done that with some of our acquisitions. Alternatively, we look for a good, local organization which is more the case with Argentina; good, small, local, closely-held company, and where we can put our products in and accelerate the growth of our products versus just trying to develop the market organically. So, give us a head start on that, and the Argentina market, if any of you have ever been to Buenos Aires, you know that the steaks hang off the edge of the plate there. They're known for their -- the best, they'll tell you they have the best steaks in the world. So, there's a lot of beef business to be had in Argentina.

Mike Ryskin: I was just speaking with a client at dinner last night, that I went to Argentina three years ago and five of the best meals of my life were steak, steak, steak, steak, steak there. So, I can affirm that. Might be -- might need to do some due diligence there in the coming days.

Richard Johnson: Right. Right.

Mike Ryskin: Switching topics a little bit, you've talked about expanding into companion animal space in recent years.

Richard Johnson: Right.

Mike Ryskin: And on the last earnings call, you made a pretty big announcement that you're developing a product for canine Lyme disease. I realize it's still very early days, but can you talk about your efforts there and sort of what the longer-term view is, and what the opportunity is?

Richard Johnson: I'd say we're an entrepreneurial organization. So, we see opportunities. We think there has been a fair amount of disruption in the companion animal space. We think there are ways to get a product, a novel product, a product that has somewhat good demand for it, that there are going to be ways to get that to market without the traditional large sales force. It's early days. Largely what we're saying is, we're going to invest in some of these development opportunities. We're going to invest P&L dollars over the next couple of years, and we'll see where it goes, but we're excited about the opportunity.

- Mike Ryskin: And is there -- would the technology that you have on board, and with this collaboration, is there the ability to leverage it to other targets as well?
- Richard Johnson: I think the -- not necessarily the specific product, but the concept maybe. It's too early to say, but potentially, yes.
- Mike Ryskin: All right. Are there any questions from the audience? I can keep going, but -- all right. I mean, this is a question we get a lot about competition in the space, across the animal health universe, because so many of the larger companies are embedded in big pharma or private. There's a lot of news obviously, with Elanco potentially deciding to spin or not to spin; there's always questions on what Bayer's going to decide to do. How does that affect your business in your conversation with customers? If something comes up on the salesperson level, I mean, this is something that you feel like you have an advantage because you are one of the two major standalone livestock therapeutics companies?
- Richard Johnson: Yeah, look, we've been competing with all of those folks for a long time. Since we've been in business. So, we've been -- and we've been competing successfully. If you look at our sales growth, we think we have a broader kind of a mindset, to bring a solution to our customer, to the producer. One of the things that frankly, we had to do within our own organization, and that we see, is that people with sort of a pharma background, and a regulated pharmaceutical mentality, is it's harder to sell some of the other non-pharma products. And given some of the underpinnings of our business, we've had very good success at that, and I think that's a positive. So, we can go to our customer, and we're offering if you want a regulated pharmaceutical, fine. If you want a nutritional specialty that has other benefits, and we've developed large amounts of data and field trials to prove the economic benefit of that product, that's great, too.
- So, we've been able to offer, I think, a broad variety of solutions to our customer.
- Mike Ryskin: Great. I think there's some questions, always, in terms of given that there's not a ton of visibility from some of the other players, about the -- and this is a relatively new area for a lot of investors, the specificity of some of the products and how they're used in particular. So, we have clients asking us, what differentiates a Phibro product from a Zoetis product, for livestock. And it really goes, it goes to the point that OmniGen, Magnify, Virginiamycin, all these drugs, have very specific indications. It's not just a broad, oh, cattle is sick, we're just going to give it whatever drug we can. So, can you talk about the breadth of the portfolio, and how much do your sales folks actually run into competitive share gains and losses with particular products? How you're bedded in the protocols?
- Richard Johnson: It depends on the product category. So, in the nutritional specialty category, we compete relatively little with the big pharma players. It's much more of a fragmented market. We see a lot of privately-held or smaller players, not the international players. So, that's one set of competitive dynamics on the more traditional regulated side. The pharmaceuticals or vaccines. Yes, we're out there with, and competing with, all the names you know.
- So, and it's really about whose product is the best for the producer's situation. So, in some cases -- in many cases -- we each have our own unique product, but it's -- the competitor will also have something that addresses the same situation. So, it's whose product is going to work the best.
- Mike Ryskin: And then speaking about the fragmented nature of the nutritional specialties market, just on that topic, you've done some nice M&A deals to bring in products before. What's the

opportunity there to expand, given, as you've said, it's such a growth driver for you? Is it more about valuations, or opportunistic targets?

Richard Johnson: Valuations are certainly substantial, no question. I think our opportunity is to do what we've done in the past, which is to bring in good ideas, good technology, at really the -- I don't know if you'd call it development stage, or at the early commercialization stage, and marry that good idea from an outsider along with our technical and sales force to really commercialize the product. And then, what we've done in the past, is we've commercialized the product under some sort of a royalty arrangement, and then we bought out the IP at the appropriate time. And then, once we control the full profit structure, were able to put more resources behind growing the product and really help that product take off in the market, then grow even faster.

Mike Ryskin: And then, on the margins and on the bottom line, I mean, a lot of this -- both for gross and operating EBITDA, a lot of this is tied to the product mix. You have the mineral nutrition business, which is tied to commodity pricing, is relatively low EBITDA margin, you have performance products business. So, can you talk about how the margin evolves over the next one, three, five years in terms of what the mix, the shift is going to do?

Richard Johnson: I think our margins will continually expand. They'll expand incrementally and not -- they're not going to explode, but they'll expand incrementally and they'll -- it'll be fundamentally mix-driven. So, we'll grow our animal health business faster than we grow the other parts. Within animal health we will grow higher margin products faster than lower margin products. So, we'll get a nice mix benefit as we go along.

We make -- in the animal health segment we make something north, we make over 70% of what we sell out of that \$500-plus million of sales. And so, we have found manufacturing efficiencies, production efficiencies over time. We think those are, there's still more to be had as we fine-tune our process, number one, and more important, number two, as we grow volumes we're able to add incremental capacity at incremental cost. So that's also a nice margin driver.

And then, over time, to the extent we're not investing in new initiatives, we can get operating expense leverage. I think in the next couple of years, what we're saying is, we're going to probably be investing in some new initiatives, and that will temper profit growth.

Mike Ryskin: And I realize there's a decent amount of product difference between the US and international markets. You talk about the nutritional specialties, it's primarily in the US but on a like-for-like product, is there a dramatic difference in gross margin and EBITDA margin, domestic versus international, is there some ability to get price there, or --?

Richard Johnson: International markets are maybe slightly less profitable on a percentage basis, but not meaningfully. We're more than happy to grow internationally, the margins are good. Yeah, the P&L profile is good. So, it's a very positive part of the business.

Mike Ryskin: All right. Any other questions from the audience? All right. As we close the end of the half hour, we have this standard question of, what's misunderstood, what's underappreciated about the company. I think you've addressed a lot of the issues here, and as we talked about, the MIA headwinds. But if there's anything that stands out to you? If nothing's misunderstood, that's fine too!

Richard Johnson: No, I think we've covered it.

Mike Ryskin: All right?

Richard Johnson: Yeah.

Mike Ryskin: Thank you very much.

Richard Johnson: All right, thanks.

Mike Ryskin: For joining us.

Richard Johnson: Take care.