PhibroAnimalHealthCorporation

September 13, 2018
08:35 AM EDT

David Risinger: So thank everybody for joining us for the session with Phibro. I just need to refer you to disclaimers at www.morganstanley.com/researchdisclosures. So it's my pleasure to welcome three members of the executive team. Jack Bendheim is the Chairman and CEO of the company. He served as the company's president since 1988 and was appointed CEO in March of 2014 and he has led the extraordinary growth over the last several decades of the company.

Dick has served as CFO of Phibro and yes, he's at the end, since September of 2002. And Dani Bendheim is the head of corporate strategy. I believe that's your current title. He's also run certain businesses at the company over the last several years.

And so once again, thanks for joining us today.

Jack Bendheim: Thanks for inviting us.

David Risinger: I thought it would be good for you, Jack, to maybe just start by framing Phibro's business for those who are not too familiar with it, and then we'll go into some more detailed questions.

Jack Bendheim: So Phibro Animal Health, as is the name, is a company that's focused predominantly in the production animal business. So it's cattle, dairy cattle, chicken, pigs, and growing in the aqua area. In providing for this growing world and growing population, growing wealth, providing animals that are healthy and if animals are healthy, they grow better and they provide a safer food for people to eat.

So that's our major focus and recently, we've started doing some investigation to enter the companion animal business and we see some interesting opportunities there, which I think we'll talk about a bit later. But the focus of the company has been for many, many years the production animal business. We do this internationally. I think today, we operate in 15, 16 countries. We market products in over 60 countries, over 3,000 customers and it's a great business with lots and lots of opportunity because people every year want to eat better and eat more, and especially in the growing economic zones of the Far East, of Africa, of Latin America, there are amazing opportunities.

David Risinger: That's helpful. And could you just provide a little bit more perspective, and maybe Dick you want to comment as well, just to frame the businesses numbers, right, in terms of U.S., ex-U.S., and the profile of the company from a financial standpoint.

Dick Johnson: Sure. Our fiscal year just ended. We reported $820 million of sales. Almost all of that, 95% of that was focused on the production animal business that Jack talked about. Within that, the business we talk most about and is the driver of growth and profitability is our animal health segment, $530 million. On a consolidated basis last year, we had $129 million of EBITDA. We've been growing steadily. That $129 million grew from $120 million the year before. Solid balance sheet. Positive cash flow. Gross leverage at June was about 2.4x. So in our guidance for this upcoming year, we're looking for topline growth of, say, up to 7%. So taking sales up to as high as $875 million.

But at the bottom line, we're looking for roughly flat year-over-year EBITDA or adjusted EPS depending on your profit measure. And we're really looking at fiscal 2019 as an investment year, looking to do a number of strategic investments, spending money off the income statement and we'll talk more about that as we go forward.

David Risinger: And the mix of U.S. versus ex-U.S.?

Dick Johnson: The mix of U.S., within that animal health segment, the $530 million, ex-U.S. is approaching 60%, roughly, and that 60% is spread really across most of the world, Latin America, Asia-Pacific, and various EUMEA countries, focused in some of the developing markets. And the United States a little over 40% of that.

David Risinger: And the performance of your business is particularly attractive given some of the very large competitors that you compete with, and also, I'm assuming you're competing with local players in certain markets, in certain circumstances as well. Yet, your company is performing slightly above industry growth. So could you talk about your competitive advantages and the differentiation that Phibro Animal Health brings to make that happen in the face of a competitive world out there for food animals?

Jack Bendheim: So you're right, there's no end to competition. We face some big competition here in the U.S. and the same companies around the world, and the ones you know so well. I think where we have an advantage and we have proven this advantage is as the world -- and sort of led by the U.S. -- as the world is getting to be more concerned about AMR, antibiotic resistance, we as a company have grown out of the nutritional side. And we acquired Pfizer's antibiotic business, MFA business in 2000. And there is a continuing role for antibiotics. Animals do get sick and so we understand that.

But we also understand how to utilize nutritional products where you can replace antibiotics. And I think we do it better than our competitors. So in this sort of new world, we have achieved very, very nice growth in our nutritional specialties. We've done them both in the States and in other markets around the world. We've entered the vaccine business. We have some niche products. We have some very, very good technology coming out of our poultry vaccine business in Israel and we also have some closer to ground technology in the U.S. on our swine vaccine, which are based on going to the farms, picking up the isolates, finding out what exactly is going on, and then delivering a vaccine that works specifically to what's happening on the farm.

So they're more expensive but more powerful and more effective. So as sort of what's happening partly in the world, especially in the U.S., as we lift off this cover we've had of antibiotic use. And in many cases, covered all sins, we expose the animals now to various disease pressures. So the animals, in order to avoid getting sick or sicker, the use of vaccines, the use of special nutritional products to prevent diseases is growing and we're right in the thick of that.

David Risinger: That's great. And obviously, you've done a great job of doing some niche acquisitions and specifically positioning the company to make that happen. And I guess just one more sort of technical question. So another thing about your business as I understand it is within MFAs, the vast majority of your revenue is animal only antibiotics, right. So you have very little medically important or shared class antibiotics and that's an important aspect as well, given the move away from medically important antibiotic use in animals. Could you just talk a little bit about that as well?

Jack Bendheim: Well, part of the problem is really nomenclature. So what is medically important in the United States has a different necessary criteria coming under the WHO where they view all antibiotics as being important but they have three criteria. But in those criteria, we're not a sort of -- sort of in use in the medical world, we're not -- our major products are not medically important. So you have to get away from the designation in the U.S. called MIA, medically important antibiotic, and just talk about what really is used.

So in the U.S., we have come to the concept of shared-class, which sort of our friends at Elanco invented. We don't have a shared class. Our biggest product is not a shared class. There is no use of virginiamycin, which is a (inaudible) product in human health. And the human equivalent is a product called Synercid, where in the whole world, the U.S. is the last market where it's still sold and it's hardly sold, under a couple million dollars a year.

So it has no impact on antibiotic resistance because you're not resistant to the product that's not being used. So to your point, David, I think of all the choices, I think people looking, and they have a sick animal, they're going to tend to want to use a product that will not cause antibiotic resistance. Feel better about that. And I think to that end, we have advantage on our major products.

David Risinger: That's very helpful. Maybe we could transition and Dani, you could talk about the corporate strategy and how you're growing the company. And then I wanted to follow-up and ask a little bit about how you're thinking about potential expansion into companion animals down the line.

Daniel Bendheim: Sure. So as Dick had mentioned, this coming year we're actually increasing our SG&A spend. I think as the markets have come to realize some of the benefits of animal health industry, the smaller companies out there that historically were companies that we would look to buy have increased their own valuations to levels that we think are not reasonable based on what they've proven to date. So we've actually moved a little bit further back in the research chain, typically where historically we might have bought a company that had just commercialized or was about to commercialize a product. We might now take a step back.

So I think what you're seeing this year is increased spend on products that are probably a year away from actually hitting the market versus where we historically were, where we were to enter a license with a company and hit the market right away with that product. And that's the reflection of the lag in this year's EBITDA. But certainly, we're very excited about many things in our pipeline.

We've got three or four products on the nutritional space that are up and coming that for us, we kind of look at $10 million as the threshold of a successful product within our industry. Very few products hit the $100 million within the nutritional space. But a $30 million or $40 million product would be in baseball parlance a grand slam. So we have a number of products, which we're pretty confident they're going to surpass the $10 million mark, already in our portfolio. We've got three or four up and coming that we're fairly confident are going to hit that and overall, we're spending a lot of time on looking to in-license or do some basic research on nutritional products, as well as on the vaccine space.

We've done some deals both as far as manufacturing capacity. We announced a deal to buy a facility in Ireland late -- I guess early this year, early this calendar year. That will take a couple of years to be up and running. It was a former vaccine facility that had been decommissioned. So we will take a couple of years to open that up and what that does is one of the things if you listen to Dick's remarks about the markets that we're in, one of the markets that we're actually not very present in, but we're starting to build our presence is Europe. And historically that's because when we bought the MFA business from Pfizer, they had exited Europe. And so as Europe was, as my father had said, antibiotics covered a lot of sins so everybody was using antibiotics, including in Europe. There's a lot of pushback there.

Europe is now transitioning more towards nutritionals, and vaccines, and things of that nature, and we see our experience in the U.S. as giving us a strong entry there as well. So that's a huge market. That's the second largest worldwide market and we are just right now a small player and we have plans to grow very rapidly there as well.

So all of these things are kind of the spend you're seeing this year on the SG&A as well as on the R&D side. And we're pretty bullish about it. Then to your next question on the pet side.

David Risinger: Yes, how are you thinking about that in terms of optionality for potential expansion in the future?

Daniel Bendheim: So we've announced a specific deal that we're working with a company on a novel delivery method for Lyme vaccine. I think if you look at what's been successful overall of late in the pet area, it's obviously meeting unmet needs. It's also meeting needs, though, in ways that are better for the customer. Whereas if people are loathe to give their animals or dogs shots, if you can figure out a way to give a dog a product through some other method, that has been shown to open up a market that seems small on paper and could be much bigger.

Daniel Bendheim: So we're progressing there. So the optionality is we look at -- we have a blank sheet in front of us and we're the largest animal health company, or the top 10 at least, not to have a pet side. So there's a lot of people there that have kind of a vested interest in keep doing it the way they've been doing it. And as novel products come out, if they -- the threat to the way they've been doing business, it's hard for some of our larger competitors to necessarily bite that bullet and go down that other path.

So we're seeing some very interesting ideas. Again, we're focused on the nutritional side and on the vaccine side. We're also looking though -- so in this time as we look at some unique products, we're also looking at unique ways to get to a customer. There's a lot of disruption going on, on the pet side as far as delivering products to the vet or to the customer and I think we're in the midst or starting in this year of testing both the products as well as the way to get to the customer. And that's what we'll be spending a lot of time on over the next few months.

David Risinger: That's very helpful. And I often get questions about the risk of future regulation on the use of products in animals. And my response to that is clearly, the FDA made changes a few years ago. I guess the hard date was January 1 of 2017. That's behind the industry and I'm not aware of any discussions about new regulations that would constrain the use of products in livestock in the U.S. or in Europe, which is already quite restrictive. But am I missing anything?

Jack Bendheim: No, I don't think you're missing anything. I think it's easier in the ag business to take big jumps. It's harder in the human health business. So I think they took a big jump a few years ago. We know from the data we're seeing that the results are quite positive as far as the regulatory bodies would be concerned. In many ways, it's easy to pick on the animal health space because no one does the numbers and no one views how many chickens are grown in the United States, versus how many people, versus levels of antibiotics.

But we're seeing I think a positive result throughout the industry and what the FDA has done here. So we don't see anything shocking coming out. We see these trends, and for us, in many ways, the trends are our friend. As I said earlier, one of the things and why we're doing better than our competitors is realizing these trends and realizing you can't fight them. We're jumping on board and jumping ahead, and coming out with unique products to help our customers.

Because at the end of the day, and I've said this many times, we can pass any regulations but someone has to tell that to the bacteria. And since no one has figured out how to tell it, the bacteria is still out there and they have to be dealt with.

David Risinger: So let me pause there and see if there are any questions from the audience. Okay. Maybe we could pivot to some of the most recent transactions and you can talk about, maybe Dani, if you want to talk about some of the most recent deals that were done and progress in moving those forward within Phibro Animal Health.

Jack Bendheim: Let me jump on the Biotay first.

David Risinger: Okay.

Jack Bendheim: That was the deal we did, a small Argentina operation. It was concentrating on the vast bovine - the vast meat business in Argentina. We decided to get in with the change in politics down there, and as Argentina started and is starting again to get into the international market of exporting its beef, it's the second largest or third largest beef producer in the world. It was out of the market under the old political regime. The new political regime now is always there's surprises every day in the currency, but this is a business which is hard dollars exporting these products. We're bringing dollars into the country so the country is behind it.

The company we bought had a significant market share providing different ranges of products to the cattle industry, both on feedlot and range. And we bought it to move the products that we have into that market and it's moving very nicely. So that's part of our overall focus of increasing our presence in the cattle business around the world, which we have done since we acquired the business.

The next acquisition, the small one --

Daniel Bendheim: We bought -- we mentioned Sligo, the vaccine facility. So it's not (inaudible).

David Risinger: That's right, yes.

Daniel Bendheim: That was probably our most recent acquisition.

Richard Johnson: And then I think closing out the PRRS deal early.

Daniel Bendheim: Right, so we bought MJ Bio, a company that we had -- historically, one of the things that we've done pretty well is we'll reach a deal with a company that has a new product where we'll go ahead and say, these might be a mismatch on valuation. They might say that hey, we're the next Zoetis and we might disagree. And what we'll say though is we'll help distribute your product. We'll grow your product but we have a set kind of put call or (inaudible) purchase at the end of it, where it will be lower than market at that point, but it's more than you would get today.

So we help them grow and then at the end, we get a price that's good at that time. And that's what we did and this product -- this is a business that we were expecting to buy in a couple of years. The deal I think was signed two or three years ago. It made sense for the parties. Tax laws change and things of that nature to act a little faster and we did that.

So we've closed that deal today and it actually has a small benefit for us within our P&L as well.

David Risinger: That's great. Very helpful. And maybe we could look a little bit further out on the financials. Obviously, you've given the guidance for fiscal '19, Dick, but how should we think about the opportunity for more leverage on the P&L in terms of margins? Obviously, this is a flat year, as you've described. But looking beyond 2019, maybe you could provide some color looking further out.

Dick Johnson: So a question we get frequently is what about the -- because we talk about these products groups and people ask about the margin mix of -- how good is the margin of a nutritional specialty product versus a more traditional MFA product, versus a vaccine. And the answer is the fastest growing or the faster growing products are better margin products than our overall portfolio. So we're going to continue to see a favorable mix benefit as we grow our business going forward. And our guidance in '19 is the sales growth is heavily leveraged to those higher margin segments.

So I just think we'll see that in the out years as well.

David Risinger: And then with respect to the mix, so obviously, international is already 60% of sales. But the U.S. is one single market and it's obviously a lot of leverage when you've launched let's say a new product in the U.S. But if you launch a new product ex-U.S., it may be distributed among many different countries where you have different infrastructure, sales force, et cetera. So the question is, as international continues to grow, is there any risk that that is lower margin for the company and constrains the company's margin outlook? Or do I have that wrong, that I shouldn't be thinking of international as being lower margin than the U.S.

Jack Bendheim: I think international is not necessarily lower margin than the U.S. But you are right. As we build out these international markets and as we convert from distribution to direct sales, and we open our own offices, I think in the course of this year we're looking to open two or three offices in the Far East, there will be a ramp up. But eventually, being on the ground, I think what we have overall seen is that margins are quite similar to the United States. It just takes a few years to get there but when you're there, you see more opportunities in these countries because they're growing very fast.

Dick Johnson: As sort of evidence, David, if you look at our year just completed, within the animal health segment, more than all of the sales growth came from the international side of our business as our domestic business actually contracted because of this antibiotic discussion and some other things. And we saw our overall profitability go up in the segment as a ratio.

David Risinger: Got it. Okay, that's helpful. And maybe you could just comment on the cash flow prospects for the business.

Dick Johnson: What we've said in our guidance is that we expect to be cash flow positive. Our CapEx tends to be somewhat lumpy depending on projects. So the year we just finished, our CapEx was quite low at around $20 million. We've said we see more projects in the coming year. So we forecast about $40 million. If you want to go to that free cash flow metric of operating activities minus CapEx, you're probably in the $40 million to $50 million range for the year.

David Risinger: Great. Thank you. And I guess the final question we have as we wrap up is when you speak to investors that are let's say more cautious or skeptical on the prospects, what are some of the things that you think they underappreciate, Jack?

Jack Bendheim: So all the investors we speak to are quite optimistic about our prospects. So those discussions never come up. I think the overhang of MFAs, I mean, just the definition of medicated feed additive, again, it's not understood. It's not all antibiotics. There are a lot of products that are regulated that fit into that basket. I mean one of the best ways, maybe the best way and the most inexpensive way to get a product, a new product into an animal is through feed. The most expensive way is to vaccinate.

So in between that is water. So we look to put as many products as we can through the MFA category. Again, not all of them are antibiotics. There's a whole range of other products. So when people look at the number, everyone gets very excited and says, oh my god, look at the drop you had in the U.S. Are we facing that in the rest of the business. So we go through it as often as we can. Some people look at the feedback, look at the performance and say, oh my god, why didn’t I buy the stock when it was $30 and now it's at $50 some the other day. So that's one attitude.

And the other attitude is let's sort of wait and see where this is going, where the story is going. We are very optimistic, as I opened up, about this business, about the trends around the world. There is lots of pulls and pushes right now. There's trade wars. You have the dairy prices being very low. But at the end of the day, you really have a business that's driven by something as fundamental as people eating a piece of chicken, or ham, or steak. I mean that is fundamental and while the United States, we're -- people in the room now are experimenting with naturally grown meat, around the world, people in Vietnam, and in Indonesia, and in India , they're just getting there. They're not ready to spend $25 for a hamburger. They're just getting there for the first time in their lives and our experience, the experience of everyone is once they've done it, they don't go back.

So I always tell the story that we have someone who works for us who went on a mission 35 years ago to Indonesia for the Mormon Church. And in this village he was working in, they would have one chicken a month. It was like a big party. And he recently went back to that village and there's something like four chickens a week. So wow, that's amazing. You look at that growth in terms of population of 400 million people and you think of it. The potential growth for our business and our competitors' business is huge. And that's why we're so excited.

David Risinger: Great. Well, that's a great way to finish up. Thanks again for joining us. Appreciate it.

Jack Bendheim: Thank you.