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Phibro Animal Health Corporation (PAHC)
Q2 December 2018 Earnings Call

CORPORATE PARTICIPANTS

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

Richard G. Johnson Phibro Animal Health Corporation - CFO

CONFERENCE CALL PARTICIPANTS

Kevin Kedra G. Research, LLC - Research Analyst

Michael Leonidovich Ryskin BofA Merrill Lynch, Research Division - Associate

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Phibro second quarter financial results conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Mr. Richard Johnson, Chief Financial Officer. Sr, you may begin.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Thank you, operator, and good morning, everyone, and welcome to the Phibro Animal Health earnings call for our second quarter ended December 2018. On the call today are Jack Bendheim, our Chief Executive Officer; and myself, Richard Johnson, Chief Financial Officer. We will provide an overview of our quarterly results, and then we'll open the lines for your questions.

Before we begin, let me remind you that 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 of this morning's call, which can be accessed on the webcast as well, and 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 section 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 in our earnings press release for a discussion of these measures. Reconciliation of these non-GAAP financial measures to the most directly comparable U.S. GAAP measures are included in the financial tables that accompany the press release.

Before we get into the numbers, we want to remind everyone that we present our results on a GAAP basis and on an adjusted basis. Our adjusted results exclude acquisition-related items; unusual nonoperational or nonrecurring items; other income or expense we report separately on our P&L; and the income tax effects related to any pretax adjustments as well as unusual or nonrecurring income tax items.

So with those formalities out of the way, I'll turn it over to Jack Bendheim for a few opening comments, and then I'll come back to describe the financial performance in more detail. Jack?

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

Thank you, Dick, and thank you, everyone, on the line for joining us. I am really proud that our core Animal Health business grew at 5%, a pace that is meaningfully faster than the overall market growth despite some of the most challenging conditions that we have faced in a number of years. Our investment in expanding our reach within South America and Asia has begun to drive significant results, as gains in these regions were more than able to make up for the headwinds we continue to face in the worldwide dairy market, the loss of a vaccine distribution agreement, as well as some significantly unfavorable currency and economic volatility in key export countries. It's disappointing to see the continued struggles of the dairy market, especially in the United States, as we are now in the fourth year of this cycle and the signs of improvement we saw last spring have clearly not taken hold.

Additionally, it's worth noting that while not a material factor in our performance so far, we're actively monitoring the effect of the African swine fever outbreak in China and neighboring countries. Beyond delivering the growth we have seen, I'm also pleased that, as a company, we reacted smartly to the challenges in the marketplace. We are actively cutting back on discretionary spending but not at the cost of delaying the many initiatives and programs we have in place to continue to drive growth in the years to come.

Within our Mineral Nutrition segment, profitability continues to be below last year. Though we are encouraged by the progressive strengthening of this business within the quarter, we are hopeful that a resolution on the trade issues with China can be reached, which would likely take some of the pricing volatility out of this segment.

I look forward to your questions, and I will now turn it back to Dick for some more details about our quarter.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Thanks, Jack. So we'll start by reviewing the highlights for our December 2018 quarter that you'd find on Page 5.

Our consolidated sales were \$218 million for the quarter, a 6% increase versus the same quarter last year. The revenue increase was driven by volume growth across all of our businesses. In addition, Mineral Nutrition revenues increased due to higher average selling prices resulting from underlying commodity costs.

Our GAAP reported net income was \$14.7 million, and diluted EPS, \$0.36 per share for the current quarter, were each more than double last year due to elevated income tax expense last year, which was a result of the initial cost of U.S. tax reform and some other discrete items.

So let's turn to Page 6 and look at adjusted results. So now looking at the selected line items from the P&L, net sales in total were up 6%. As I said, we'll look at the sales increases and the sales growth in more detail as we discuss the segments.

Our adjusted gross profit was very similar to the prior year. The modest increase in gross profit was due to two major factors. In the Animal Health segment, we saw unfavorable sales mix and higher manufacturing costs for certain of our products. And in the Mineral Nutrition business, we saw reduced margins on an unfavorable product mix as well as constrained pricing in a competitive environment.

At the adjusted SG&A (selling, general and administrative) line, we saw an increase in total of \$1.3 million over last year, and that was due to a \$1.5 million increase in corporate expenses. That's largely due to increased spending on development projects strategically to position ourselves for future growth. We've held all other operating expenses even with last year to protect profitability while maintaining those strategic initiatives.

Adjusted net interest expense increased 6% on higher interest rates and also increased debt levels compared with last year.

The adjusted effective income tax rate was 29% in the second quarter and 28.5% for the 6 months, consistent with our revised expectations. The effective tax rate for Q2 last year benefited from the year-to-date adjustment to a reduced federal statutory rate. So that was one of the negative year-over-year comparisons.

In addition, the current year provision for income taxes includes the GILTI provisions of the new tax legislation. GILTI is an acronym for Global Intangible Low-taxed Income. And our income was sort of caught up in these provisions unexpectedly. And as we talked about in our last quarterly discussion, the GILTI provision adds about 1.5 percentage points to the effective tax rate.

So now on Page 7, looking more closely at the Animal Health business. Sales of almost \$140 million grew \$6.7 million or 5% over last year. The growth was driven by volume increases in MFAs and other. Sales in MFAs and others were \$93 million in the quarter, an \$11 million or 13% increase from last year. International sales were the primary growth driver, particularly in the Asia-Pacific and Latin America regions. We saw good international growth despite unfavorable currency effects in certain countries.

Nutritional specialty product sales of \$29.5 million declined more than \$3 million or 10% from last year on weak dairy industry conditions and on lower poultry demand in the quarter.

Vaccine sales were \$17 million in the quarter and declined \$1.2 million compared to the last year, a 6% decline, as certain of our international markets were affected by turbulent economic conditions. In addition, as expected, the loss of the distribution agreement during the quarter was also a negative for the comparison.

Gross profit for the Animal Health segment increased \$800,000 on the volume growth. However, unfavorable business mix and manufacturing costs muted the increase. Segment SG&A spending was little changed from the prior year. As a result, adjusted EBITDA of approximately \$36 million for the segment increased just under \$1 million or 3%, driven by the sales growth and favorable gross profit.

So now looking at our other segments on Page 8 of the presentation. Mineral nutrition net sales of \$62 million for the quarter increased \$2.7 million or 5% from last year due to higher commodity pricing and improved volumes. Our selling prices in the minerals business generally move in direct correlation with underlying commodity costs. Segment adjusted EBITDA of \$4.1 million was a decrease of \$1.5 million from last year due to unfavorable product mix and a competitive pricing environment.

Performance Products net sales of \$16.3 million were ahead of last year, and that sales growth resulted in improved adjusted EBITDA.

Corporate expenses of almost \$10 million increased \$1.5 million last year, primarily due to investments in the strategic development projects.

And finally, just briefly looking at the balance sheet and capitalization on Page 9. Our gross leverage ratio of debt to adjusted EBITDA was 2.5x at the end of the quarter, and we had \$80 million of cash and short-term investments on the books at quarter-end.

For the quarter, we generated \$10 million of cash from operating and investing activities, excluding changes in short-term investments. Seasonal working capital needs also used cash.

And finally, we paid a \$0.12 per share dividend in December 2018, and we've declared the same level to be paid in March 2019.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Michael Ryskin with Bank of America.

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

A quick question on the international growth in MFAs and others that you highlighted. One of your competitors recently indicated that they've seen a slight pickup in movement away from medically important bacterials in some parts of Southeast Asia, similarly to what we saw with the veterinary feed directive in the United States. I was curious if you've seen any of that? And if you could characterize specifically, which parts of the MFAs and others segments you're seeing the growth in, understanding that there is a number of different products in there?

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

Right, thanks for the question. So we're seeing a growth in business. I think as I mentioned in my remarks, we've recently, in the last couple of years, we've put on more people into markets where we have not been before, in -- especially in Southeast Asia. So in many of those markets where people have not seen our products, we're growing across the range of our anticoccidial products. Mostly, those products would not fit into what, in the U.S., would be considered the MIA category. It gets more complicated when going to rest of the world because the rest of the world works off the WHO characteristics. And there, the list of where these products fall, some of our competitors call them shared, some of them call that's the mission of human-only. But when we get to the rest of the world and you look at the criteria on the WHO list, so there, our products look more favorably to some of our competitors' products because they are lower down on the list or they're in the third categories instead of the second or first category. So this whole thing and this whole business becomes quite more complicated. At the end of the day, these products are treating diseases. If there are no diseases, no one is going to use the product. If there are diseases, they're going to use a range of products, and whatever works for them.

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

That's very helpful color. And then just one quick follow-on on the outlook for the year. You mentioned some comments in the prepared remarks and in the press release on African swine fever. I recognize that swine is a relatively small part of your overall sales, but if you could just provide some details on what factors into your outlook for the rest of the year, both for ASF and underlying market conditions for dairy, for poultry, across the various Animal Health businesses?

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

So while the swine market is not that an important market for in the U.S., it is a big market for us where it's consumed around the world. Obviously, in countries that don't eat swine, it's not a big market. In countries that do eat swine, it is. Specifically, African swine fever is a growing problem in China and other markets around the world, not just in China. But the business in China, I think we've spoken about this many times in the past, I mean, China is a country raises 400 million pigs. But many, many pigs are raised on very small farms, and with the inability to do good biosecurity, and that's depressed. So there are a lot of pigs there are -- that look like they are not surviving this fever. But at the end of the day, it's not clear yet, and that's why, sort of, we put our remarks cautiously. We haven't seen a big effect up to now, and we're not sure what the fact is because this might not affect the farms that we ultimately sell our products to because they tend to be the larger farms. The ones, I often say, they can count and see the difference when they have a product in, when they don't have a product in, a MFA in. So this is something that we'll see -- we'll unfold over the next 6 months, 1 year or years. So it's not clear right now. But clearly, it is affecting the overall pig population in China, and again, it's moving to other markets.

Operator

(Operator Instructions) Our next question comes from the line of Kevin Kedra with G Research.

Kevin Kedra - G. Research, LLC - Research Analyst

First, I want to ask about in Animal Health, we've seen some weakness both in nutritional specialties and vaccine for the past couple of quarters. I know longer term, you guys have looked at these as being growth-driving businesses. I'm wondering if anything has changed on your long-term view for either nutritional specialties and vaccines.

And then just secondly, Performance Products is something we really don't talk about, but the margins on that business at the EBITDA level have been pretty strong now for the last few quarters. Wondering if going forward, we should be thinking about kind of the first half of the year run rate as the right way to be thinking about the EBITDA margin on that business. Or is there something temporary going on that's led to those margins being higher than you would normally expect?

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

So to the first half, vaccines and nutritional specialties are a key part of our growth strategy and a key part of what we're investing to go forward. I mean, we've spoken in the past about our new vaccine facility in Sligo, Ireland. We spoke about other investments. I think in -- during the last quarter, we spoke about the acquisition of an aqua vaccine company in Israel. So we continue to make investments in vaccines. It's not quick -- that quick growth, but I think the decline is mostly that we've lost the distribution of some vaccines in the United States, but we will more than make it up over next 6 months and over the ensuing years. So that is still a very important part of our growth and our growth strategy.

Nutritional specialties is to date more tied to the dairy industry, even though we are investing and moving those products out to the poultry and to the swine industry and moving those products out to the rest of the world, away from the United States. So I think we're seeing this continued decline in the dairy industry and the shift in what the market looks like in United States. But again, we are investing and we are confident that, that business will come back and we'll see growth in the years ahead. So they're both important -- very important pillars to our business.

To the...

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Performance products.

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

Performance Products, I think, sort of, it's an anomaly. We run one plant. And sometimes, when it falls that the plant -- the capacity is full, we do have better numbers, and sometimes it doesn't work out. It's still not our core business, so I would not spend too much time on it. But we're happy -- when it does well, we're happy to take the money, but don't spend any time on it, Kevin.

Operator

And I'm not showing any further questions at this time. I would now like to turn the call back over to Richard Johnson for any closing remarks.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

I'll just say thanks, everyone, for listening. It's been a pleasure, and we'll talk to you again in 90 days. Bye now.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program, and you may all disconnect. Everyone, have a wonderful day.