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Phibro Animal Health Corporation (PAHC)
Q3 March 2018 Earnings Call



CORPORATE PARTICIPANTS

Richard G. Johnson Phibro Animal Health Corporation - CFO

CONFERENCE CALL PARTICIPANTS

Michael Leonidovich Ryskin BofA Merrill Lynch, Research Division - Associate

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Phibro Third Quarter Financial Results Conference Call. (Operator Instructions) I would like to turn the conference over to Richard Johnson, Chief Financial Officer. You may begin, sir.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Thank you, operator. Good morning, everyone. Welcome to our earnings call for the third quarter ending March 2018. Unfortunately, Jack Bendheim, our Chief Executive Officer, is not able to join us today, as he unexpectedly had to attend to an urgent family matter. With us today is Larry Miller, Phibro's Chief Operating Officer; and myself, Richard Johnson, Chief Financial Officer. We will be available on the call and to answer your questions during the Q&A session.

Before we begin, let me remind you of the standard cautions that the earnings press release and financial tables can be found on the Investors section of our website at www.pahc.com. And we are also providing a simultaneous webcast of 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 section in our earnings press release.

Our remarks today will also include references to certain financial measures, which were not presented in accordance with generally accepted accounting principles, or U.S. GAAP, and I refer you to the Non-GAAP Financial Information section in 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.

So in Jack's absence, let me provide his introductory comments.

As you saw from our press release, our third quarter performance was a strong one, with Animal Health segment sales up 9% over last year. Animal Health's performance was once again led by our nutritional specialty products growth, with 14% year-over-year growth, especially as we introduced products to more international markets. We also had a strong performance from our MFA and other category, which had strong international growth, and was finally able to show its underlying strength without the headwinds resulting from the resized U.S. market. Finally, our vaccine products grew 6%, which was a nice performance in light of the reduced disease incidence, particularly in the U.S. swine market. Our Mineral Nutrition business also had a very strong quarter with double-digit growth in revenues and adjusted EBITDA.

Our continuing strong operational performance is allowing us to seek out developmental opportunities across our existing businesses as well as segments we have not entered to date. As we discussed in our press release, we recently signed a development and commercialization agreement relating to a novel delivery method for a canine Lyme disease vaccine. We are truly excited about this opportunity, and are seeking additional products to enter the pet space. Of course, development deals of this sort will drive increased spending in the near to midterm without a revenue benefit. Still, we view the long-term opportunities as more than offsetting the short-term cost, and we're confident that our underlying strength will offset the increased spend.

So now, let me continue on with the financial discussion with more detail on our financial results.

Briefly, before we get into the numbers on Page 4, we remind everyone that we present our results on a GAAP basis and also on an adjusted basis. Our adjusted results exclude various acquisition-related items, other income and expense items that we report separately; essentially today, it's only foreign currency gains and losses. And the income tax effects related to any pretax adjustments, and also excludes certain income tax items that we consider non-operational.

This quarter, we excluded the benefit of employee stock option exercises and the release of certain unrecognized tax benefits.

So on Page 5, let's start by reviewing the highlights for the quarter. Consolidated sales were almost \$209 million for the quarter, a 10% increase versus the same quarter last year. Volume growth was the driver of increased sales across all segments. And in the Mineral Nutrition segment, revenues also increased due to higher average selling prices, resulting from underlying commodity movements. Reported net income of \$19.8 million and diluted EPS of \$0.49 for the current quarter declined from the prior year, primarily due to two favorable items that were included in last year's results. Last year's results included a \$7.5 million pretax gain from an insurance settlement, and last year's results also included a \$3.8 million income tax benefit from the release of a valuation allowance on certain foreign deferred taxes.

Now turning to adjusted EBITDA. Adjusted EBITDA was \$33.4 million for the quarter, up \$3.7 million, or 12% over last year. Adjusted net income increased over last year by the same amount, \$3.7 million, or 25%, driven by the improvement in adjusted EBITDA, reduced net interest expense and the benefits of a lower effective income tax rate, primarily due to the recent U.S. tax reform, lowering the federal statutory rate. As a result, adjusted diluted EPS was \$0.46 per share, a \$0.09 per share, or 24%, increase over last year.

Turning to Page 6. We present selected line items from the income statement. Net sales increased 10%. We will have additional commentary on the sales increase in the discussion of the segments. Adjusted gross profit in total increased by \$8.5 million or 14% over last year on the volume growth and favorable mix. Adjusted SG&A or operating expenses increased \$4.7 million. To position ourselves for future growth, we increased spending in product development and organization capabilities. A new acquisition in the Animal Health segment, that was the acquisition we did during our September quarter, also contributed to the SG&A increase. As I mentioned, our adjusted net interest expense was favorable on improved borrowing rates from new credit facilities that we entered into at the end of June 2017, and the adjusted effective income tax rate was favorable to last year due to the reduced statutory federal income tax rate. In addition, our March quarter benefited from an updating of the year-to-date effective tax rate to a revised projected annual rate of just over 28%. Just as a reminder, Phibro is a fiscal year taxpayer, and our fiscal 2018 statutory federal income tax rate is 28%. It is the average of the new 21% and the old 35%, half a year of each, and we will have the full benefit of the 21% reduced US statutory rate when our new fiscal year begins in July 2018.

Now looking more closely at the Animal Health business. Sales of \$132.3 million grew over \$11 million, or 9%, compared with last year. The growth was driven by volume increases across all product groups within the segment. The effect of currency was a small favorable factor in the sales growth in the quarter. Nutritional specialty product sales of \$31.4 million grew \$3.8 million, or 14%, over last year on volume growth of products for the poultry and dairy industries in various international countries and in the United States. Vaccine sales were \$18 million, and grew \$1 million or 6% over last year on volume growth in international markets. Our domestic vaccine growth was moderated due to reduced disease pressure. Sales of MFAs and other were \$82.9 million in the quarter. That was an increase of \$6.6 million or 9% compared with last year. Within that product category, international sales of MFAs and other increased \$5.6 million due to growth across most regions, notably due to additional penetration in the cattle sector, and the recent acquisition also contributed to the growth. Domestic sales of MFAs and other increased \$1 million due to volume growth of certain products. Domestic sales of medically important antimicrobials were approximately level with the prior year. Gross profit for the segment increased \$7.5 million on the volume growth and on favorable product mix and seasonal demand for certain products, and improved manufacturing efficiencies. We increased our segment SG&A spending by \$2.8 million, including investments for increased product and organization development, and a recent acquisition also contributed to that increase. As a result, segment adjusted EBITDA of \$36.3 million increased \$4.5 million or 14% on the sales growth and favorable gross profit, partially offset by the investments in operating expenses.

Looking at our other segments. Mineral Nutrition had a very nice quarter. Mineral Nutrition net sales of almost \$63 million increased \$5.8 million or 10% from last year due to favorable product mix and higher commodity pricing. Notably, segment adjusted EBITDA of \$5.4 million was an increase of \$1 million or 24% from last year on volume growth and favorable product mix. Performance Products net sales of \$13.7 million were ahead of last year, but adjusted EBITDA was approximately even with last year on higher raw material costs. Corporate expenses of \$8.7 million

increased \$1.8 million over last year on increased development costs and employee-related costs.

Turning to capitalization and capital allocation. Our positive cash flows continue to improve our leverage metrics. Our gross leverage ratio of debt to adjusted EBITDA was 2.5x at the end of the quarter, and we had \$76 million of cash and short-term investments on the balance sheet at quarter-end. For the quarter, we reported \$18 million of cash provided from operating and investing activities. That excludes cash used to purchase short-term investments. Changes in operating assets and liabilities and other items used almost \$6 million of cash in the quarter, primarily due to inventory increases from the timing of sales, production and purchases, and the increased raw material costs in the Mineral Nutrition business. We purchased \$18 million of short-term investments in the quarter, utilizing amounts previously included in cash and cash equivalents, and we paid a routine quarterly dividend in the quarter, and have declared the same amount per share to be paid in June.

Regarding our guidance, we are not modifying our fiscal year 2018 annual guidance, as presented in our February 5, 2018 press release.

That is a brief summary of our financial results for the quarter, and the conclusion of my prepared remarks. Operator, if you would please open the line for questions. Thank you.

QUESTIONS AND ANSWERS

Operator

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

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

Congrats on the quarter, first of all. And I wanted to focus on the vaccine product. You discussed it on the call, I think, for canine Lyme disease. It sounds like a really interesting opportunity. Is there any other details you can tell us about who the agreement is with? Are there any milestone payments or sort of what the format is? And any time line on commercialization?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

The agreement is confidential, so we can't talk about any of the details. I would say, this is probably a typical development-type agreement where, at each stage of the development process, we can reevaluate and decide to continue and continue investing or not. In the press release, we talked about 18 to 24 months, and I think that's probably a reasonable time line to think about when we might first have revenues.

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

Okay, that's really helpful. And then along those same lines, you talked about the increased spend, the increased investment in the business. Is that more on the R&D front? Or is that -- changes the sales force as you get the products close to market to help you commercialize in the segment?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

I think it's more on the development side of the business, where we're looking at going into joint development opportunities, working with third parties who have interesting, novel, compelling product ideas that their idea, combined with our ability to commercialize and bring a product to market, is a winning combination. We will also continue to add people in selected geographies. So not to downplay that, but it will be both of those things.



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

Okay, great. And if I can squeeze in one more. You talked about strength in the U.S. dairy for the nutritional specialties. We've heard from some of the competitors that the challenge in the market right now and from the industry data we're seeing is certainly that the dairy market in the U.S. is -- that are undergoing some changes there are less than favorable. Can you talk about what's driving the strength there? Is there any particular product line?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

No. Maybe I wasn't -- I should have been more clear. Our strength in that segment is really in international markets. We're feeling the pain, I think, that the dairy industry and some of our competitors are feeling in the domestic market.

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

Got it. Is there any benefit from one of your major competitors recently did a strategic exit from Posilac? Any opportunity to gain share there or take over that from that strength?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

No. That was sort of a unique product to them, and no is the short answer.

Operator

(Operator Instructions) I am showing no further questions at this time. I would now like to turn the call back to Richard Johnson, Chief Financial Officer, for any further remarks.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Well, thank you, everyone. We look forward to talking again when we put out our year-end numbers, which will be at the end of August. We will talk then. I anticipate also providing guidance on our new fiscal year at that time. So until then, everyone, take care. Bye now.

Operator

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



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