

Client Id: 77

November 7, 2018  
**Phibro Animal Health Corporation (PAHC)**  
Q1 September 2018 Earnings Call

## CORPORATE PARTICIPANTS

Richard G. Johnson Phibro Animal Health Corporation - CFO

## CONFERENCE CALL PARTICIPANTS

Katie Anne Tryhane Crédit Suisse AG, Research Division - Research Analyst

Michael Leonidovich Ryskin BofA Merrill Lynch, Research Division - Associate

## PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Phibro first quarter financial results conference call. (Operator Instructions)

I would now like to turn the call over to Richard Johnson, Chief Financial Officer. Sir, you may begin.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Thank you, operator, and good morning, everyone. Welcome to the Phibro Animal Health earnings call for our first quarter ended September 30.

On the call today is myself. I am the Chief Financial Officer. Jack Bendheim is traveling internationally and most likely will not be able to join us. On the call today, we will provide an overview of our quarterly results and also some updated guidance for our fiscal year ending next June. And then, we will open the lines for your questions.

Before we begin, some of the standard things, we remind you that the earnings press release and financial tables can be found on the Investors section of our website at pahc.com. 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 on our earnings press release.

Our remarks today also will 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 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.

Before we get into the numbers, let me remind everyone that we present our results on a GAAP basis and on an adjusted basis. We present adjusted results that exclude acquisition-related items, that exclude unusual, non-operational or nonrecurring items, certain other income and expense items as separately reported in our P&L and the income tax effects related to any of those pretax adjustments, and we also exclude any unusual or nonrecurring income tax items.

So now turning to page 5, let's start by reviewing the highlights for our September quarter. Consolidated sales were \$200 million for the quarter. That was a 3% increase versus the same quarter last year. The revenue increase was driven by growth across all of our businesses, including volume growth in the Animal Health business. In addition, our Mineral Nutrition revenues increased due to higher average selling prices, resulting from underlying commodity costs.

Reported net income of \$16.3 million and diluted EPS of \$0.40 per share for the current quarter increased 3% over the prior year and were driven by an increase in gross profit due to the sales growth, offset in part by increased selling, general and administrative expenses as we invested in product and organizational development.

We saw favorable foreign exchange gains. That is a separate line in our P&L. These are primarily related to intercompany balances, and we do exclude these items from our adjusted results. And finally, income tax expense increased, both due to the higher pretax income, but notably due to the onetime effects of the exercise of employee stock options where we had a much larger favorable benefit last year.

Our adjusted EBITDA was \$30.1 million for the quarter. That was even with the prior year. We saw adjusted EBITDA increase due to improved operating results in the Animal Health and Performance Products businesses, but reduced profitability in the minerals business and by higher spending for development activities in corporate expenses basically offset the favorables.

So looking at some selected line items from the P&L. Adjusted gross profit increased \$2.3 million or 3% over last year. That was in line with the sales increase. Favorable trends in the Animal Health business were offset by reduced margins in the minerals business. We will talk more about segment performance on the next few pages.

In total, adjusted SG&A increased \$2.3 million. \$1.2 million of that increase was in the corporate departments, and \$1.1 million of the increase was in the Animal Health segment. We have increased spending on product development and organization capabilities to position ourselves for future growth.

Adjusted net interest expense was slightly favorable. We saw improved earnings from short-term investments. The adjusted effective income tax rate was 28% for the current quarter. The rate was favorable to last year due to the reduced federal statutory income tax rate that came about from the tax reform legislation in December of last year.

We now expect to be subject to another aspect of the new tax legislation, something called -- an acronym called GILTI, which is the Global Intangible Low-taxed Income provisions of the new legislation. Those provisions will add between 1 and 1.5 percentage points to our effective tax rate for the year.

Turning and looking more closely at the Animal Health business, we had sales of \$131.2 million in the quarter. Those sales grew \$2.3 million or 2% over last year. The growth was driven by volume increases in the MFAs and other product category.

Our sales of MFAs and other were \$87 million in the quarter, a \$7.4 million or 9% increase over last year. International sales were the primary growth driver and notably in the cattle sector. We saw good international growth despite unfavorable currency effects in certain countries.

Our nutritional specialty product sales of \$27 million declined \$3.8 million or 12% from last year on weak dairy industry conditions and a poultry business that was roughly equal with last year. Sales of vaccines were \$17.2 million in the quarter. That was a decline of \$1.2 million or 7% from last year as certain of our international markets were affected by turbulent economic conditions and the timing of some distributor orders also had a negative effect.

In the Animal Health segment, gross profit increased \$3 million on the volume growth, favorable product mix and on continued improved operating efficiencies. We increased our segment SG&A spending by \$1.1 million, including investments for increased product and organizational development. That left adjusted EBITDA of \$35.7 million. That was an increase of \$2 million, or 6% as the sales growth and favorable gross profit results were only partially offset by the increased SG&A spending.

Now looking at our other segments. The minerals business, Mineral Nutrition net sales were \$54.8 million in the quarter. That was an increase of \$2.8 million, or 5% over last year. The increase was due to higher commodity pricing. Our selling prices in the minerals business generally move in direct correlation with the underlying commodity costs.

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At the adjusted EBITDA line, segment adjusted EBITDA was \$2.6 million. That was a decrease of \$1.2 million from last year. That was due to both unfavorable product mix within the business as well as a competitive pricing environment.

The Performance Products segment reported net sales of \$14.1 million. Those sales were ahead of last year, and that resulted in improved adjusted EBITDA. Our corporate expenses were \$8.9 million in the quarter. They increased \$1.3 million over last year due to investments in increased development costs.

Now looking at capitalization and capital allocation. Our gross leverage ratio of debt-to-adjusted EBITDA was 2.5x at the end of September, and we had \$76 million of cash and short-term investments on the books at the quarter end. For the quarter, we used \$15 million of cash for operating and investing activities, including \$10 million used for business acquisitions. We also had some seasonal working capital needs that use cash.

Notably, we have increased the quarterly dividend by 20%. The increased dividend of \$0.12 per share will be paid in December 2018. The increase reflects Phibro's positive cash flows and balance sheet strength.

Looking at our updated guidance, we have updated our guidance -- our annual guidance based on our expectations for the effective tax rate for the full year. Because of the GILTI tax aspects of the recent legislation, we now expect the effective income tax rate to be between 28% and 28.5% for the year. The higher taxes as a result of the higher effective rate result in an adjusted EPS of \$1.68 to \$1.72 per share. That is a reduction of \$0.04 to \$0.05 per share compared with our initial guidance.

We are reaffirming our guidance for sales and profit, but we now consider it more likely to be at the lower end of the ranges provided. Animal Health sales growth in the current year will be more weighted to the MFAs and other product category. We continue to expect nutritional specialties and vaccines will grow at double-digit rates as our business develops. However, current year growth will be more subdued.

Our operating visibility for the year has been reduced by a number of negative or difficult factors, including volatile currencies, economic turbulence in some international countries, unfavorable short-term challenges in the minerals business, continued difficult dairy conditions, ongoing trade disputes and various other factors.

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

## QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Erin Wright from Crédit Suisse.

Katie Anne Tryhane - Crédit Suisse AG, Research Division - Research Analyst

Hi. This is Katie Tryhane on for Erin. We're just wondering what was the acquisition that you mentioned in the press release. And can you just elaborate or quantify that contribution?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Well, I didn't hear the word, Katie. What was it we mentioned on the press release?

Katie Anne Tryhane - Crédit Suisse AG, Research Division - Research Analyst

Oh, the acquisition.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

The acquisition. We did 2 things in the quarter. One that we talked about as part of our year-end release, we finalized the full purchase of the -- it's called MJB swine vaccines in the United States. That was the bulk of the spending in the quarter -- the business acquisition cash flow in the quarter. That was a swine vaccine. We also bought a small vaccine manufacturer and sort of a developer, which we haven't released more information about, but we did acquire some interesting technology and potential products for the aquaculture industry.

Katie Anne Tryhane - Crédit Suisse AG, Research Division - Research Analyst

Okay. Got it, that's helpful. And then can you just speak a little bit more to when you could get back to double-digit growth in vaccines and nutritional specialties?

Richard G. Johnson - Phibro Animal Health Corporation - CFO

It's hard to say precisely when. I think we will -- as we said, we're seeing this year our visibility is probably more cloudy than it's been in a while as far as what our customers are thinking, how their businesses are progressing. So I'm hesitant to say precisely when. I think it will be -- it's hard to say when. So can't really put a date on it. But I think we still have a lot of confidence and belief in the portfolio. And we see our customers more and more broadly accepting the fact that these are kind of the best products for them to use. But there's a lot of other factors affecting our customers right now.

Operator

(Operator Instructions) And our next question comes from Derik De Bruin from Bank of America.

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

It's Mike Ryskin on for Derik. A couple questions. I want to start with sort of your closing remarks there. You talked about all the challenging conditions. I think the biggest one in my mind, and correct me if I'm wrong, is the challenges in the dairy markets and how that's affecting the -- some of the nutritional specialties. That's been ongoing for some time, but it seems like it's really in the broader market gotten worse in recent months. Do you have any sense of visibility into when that will improve? Because in my understanding, it's mostly tied to just the blood in the market in terms of oversupply, but if you could just talk about the dairy markets in a little bit more detail?

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Richard G. Johnson - Phibro Animal Health Corporation - CFO

Yes. Most of this-- this is a global problem, Mike. But most of our business today is in the United States. What we're seeing is dairy producers, the farmer, are just getting squeezed unmercifully by the supply-demand imbalance. And so this is only going to sort itself out when the industry sorts itself out in terms of only the strong survive and some of the weaker players fall away and supply comes back into more of a balance. There's also global factors of how much of dairy products-- and when you think of dairy, everyone thinks of liquid milk, but really we're talking about skim milk powder, whole milk powder, components of dairy, really that go into many foods around the world. So I think this has been lower longer than many people have expected. The industry will come out of it at some point, but hard to put a timeline on when that might happen.

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

All right, thanks. And I was-- especially in vaccine and some of the other segments you talked about the international impact on some of the timing. I was curious if there was-- if you could break out a currency straight FX impact as well.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Yes. Actually, it is not so much just the currency, but the fact that in many markets we price in U.S. dollars, but if the local currency devalues by 20% or 30% or more percent, all of a sudden, that customer's price in his market has gone up by 20% or 30%. So it's a complicated equation. We don't have a precise number I can give you, but I can tell you it was a negative to our business in several markets. And then in some markets, we do price in local currency. And there, we have seen currencies devalue, and that has hurt our top line and hurt our profitability too.

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

Okay, thanks. And then one last one, if I could squeeze it in. You talked a lot about investment in SG&A, investment in the portfolio. If you could give a little bit of color on whether the investment is going to the commercial sales force or the R&D, the product pipeline. And specifically on that, if you could talk a little bit more about any products that are coming up that we should keep an eye on? Or if you have any progress on some of the companion animal investments going on there?

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Richard G. Johnson - Phibro Animal Health Corporation - CFO

I'd say our investment is more in -- so, first of all, our investment is focused on the nutritional specialty and vaccine categories. It's really pipeline development. In the case of vaccines, we're looking at some new products. We're also building out and developing the idle vaccine facility that we purchased 6 months ago or so. We are spending money on that as we ramp up that facility. Products -- I can't give you any specific products, but those are the categories that we're working on. I would say in the companion animal space, we are -- we continue to make progress, both in the product that we talked about previously and another 1 or 2 products. We could be out there at least doing some test marketing in perhaps the next 6 months. But it's too early to really say where that might go.

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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.

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Richard G. Johnson - Phibro Animal Health Corporation - CFO

All right, everyone. That's a wrap for today. We'll talk to you again on our next quarterly call. So until then, take care. Bye now.

Operator

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



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