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**Phibro Animal Health Corporation (PAHC)**  
Q2 December 2017 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

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

**Onusa Chantanapongwanij** Morgan Stanley, Research Division - Research Associate

**Tyler Lee Etten** Piper Jaffray Companies, Research Division - Research Analyst

## PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Phibro's Second Quarter Financial Results. (Operator Instructions) As a reminder, this conference call may be recorded. I would now like to introduce your host for today's conference, Mr. Richard Johnson, Chief Financial Officer. Please go ahead.

**Richard G. Johnson** - Phibro Animal Health Corporation - CFO

Thank you, operator. Good morning, everyone. Welcome to Phibro Animal Health's Earnings Call for our Second Quarter ended December 2017.

On the call today is Jack Bendheim, our Chief Executive Officer; and myself, Richard Johnson, Chief Financial Officer. We'll provide an overview of our quarterly results and our updated guidance for our fiscal year, then we'll open the line up for your questions.

Before we begin, let me remind you that the earnings press release and financial tables can be found in the Investors section of our website at [www.pahc.com](http://www.pahc.com).

We're 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 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 on 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 press release.

So with that, here is Jack Bendheim with some introductory comments. Jack?

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

Thank you, Dick, and thank you, everyone for joining us on today's call. More than a year ago, we knew our domestic business was going to face near-term challenges due to the regulatory and consumer driven changes that were centered on reducing antibiotic usage, particularly in poultry – a major sector for us. We made the strategic decision at that time not to retrench but rather to increase our investments, in people, products and

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infrastructure, recognizing that unchanged bacterial and disease pressure were going to continue to drive the need for innovative solutions. We were convinced our customers - more than ever - would need the people, technology and processes that embody Phibro. We were convinced that in the medium to long term, we would be rewarded for making these investments.

I'm thrilled we made the decisions we did, for as we enter 2018, we have never been better positioned with the solutions and expertise needed by our customers around the world. We anticipate the second half of this year will see each of our Animal Health product categories grow at/or above market rates. The MFAs and other category, our largest segment, benefits from a stabilized U.S. environment and continued strong growth internationally, especially from the continued recovery in Brazil and opportunities around South America and Asia.

We continue to see double-digit growth from our Nutritional Specialties and Vaccines offerings as we focus on selling more products to more markets around the world. Our balance sheet continues to strengthen and we remain active in looking at business development opportunities. At the same time, we remain committed to the path of strengthening our internal capabilities, a strategy that we believe is only beginning to bear fruit. As you can tell, I'm quite excited about the opportunities ahead of us and I'm looking forward to answering your questions in further detail following Dick's detailing of our performance for the quarter and our revised guidance. Thank you. Dick?

**Richard G. Johnson** - Phibro Animal Health Corporation - CFO

Thanks, Jack. Before we get into the numbers, just as I said a minute ago, I want to remind everyone that we present results on both a GAAP basis and adjusted basis. To explain a little bit more, our adjusted results exclude acquisition-related items such as intangible amortization, inventory step-up or cost of goods sold costs, accrued compensation costs related to acquisitions, other costs -- other related costs like transactions or accrued interest. We also exclude any unusual, nonoperational or nonrecurring items and for income taxes, we exclude unusual or onetime items, for example, this quarter, we had all of the items around the effects of the tax reform bill. We also adjust income tax expense for the effects related to any pretax income adjustments we make.

So with that, let's look at Page 5 and start by reviewing the highlights of our December quarter. Our consolidated sales were almost \$206 million for the quarter. That was a 7% increase against the same quarter last year. The increase was driven by volume growth in the Animal Health segment and favorable product mix and higher average selling prices that resulted from commodity pricing in the Mineral Nutrition segment.

Reported net income, that's on a GAAP basis, of \$7 million and diluted EPS of \$0.17 for the current quarter declined from the prior year, essentially due to the income tax-related onetime or unusual charges from tax reform and some other items that were recorded in the quarter.

Our reported income before income taxes improved over last year due to several factors, including the growth in gross profit, which was driven by sales growth. Gross profit increased despite a \$1.4 million charge for the cost of the inventory step-up cost or additional cost of goods in the quarter. We did increase our selling, general and administrative expenses as we continue to invest in product and organizational development. The comparison to last year benefited because last year included a charge for pension settlement costs. In addition, benefiting our P&L both on a GAAP reported and adjusted P&L basis, we reported reduced net interest expense due to lower borrowing rates from our recent refinancing and new credit facilities.

Adjusted EBITDA was \$32.5 million, that was up \$1.3 million or 4% over last year. We'll get to more color on adjusted EBITDA as we look at the individual segment performance. Adjusted net income increased \$2.3 million or 15% over last year. The adjusted net income increase was driven by improvement in adjusted EBITDA and by reduced net interest expense and by the benefits of tax reform.

Adjusted diluted earnings per share was \$0.44. That was a \$0.05 per share or 13% increase over last year. The growth in adjusted diluted EPS was slightly less than the percentage growth in adjusted net income, as diluted shares outstanding increased slightly compared to last year.

On Page 6, we present selected line items from the P&L. Net sales increased 7%. We'll take that number apart as we look at the segments on the following slides. Adjusted gross profit increased in line with the sales growth or 7% also. Adjusted selling, general and administrative increased \$3.8 million in total, due to an increase of the same amount, \$3.8 million, in the Animal Health segment. To position ourselves for future growth, we increased spending on product development and organization capabilities. A recent acquisition also contributed to the SG&A increase.

Our adjusted net interest expense was favorable on lower borrowing rates, and the adjusted effective income tax rate was favorable to last year

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due to the reduced statutory federal income tax rate from tax reform. In addition, the rate for the quarter benefited from adjusting the year-to-date rate to the new lower level. Because we are a fiscal year taxpayer, our statutory rate for our fiscal year ending June 2018, is the weighted average of the old rate and the new rate. So our rate for this fiscal year is about 28%. We'll get the full benefit of the new 21% rate when we start our new fiscal year, beginning July 1, 2018.

Now we look a little more closely at the Animal Health business on Page 7. We had sales of almost \$133 million in the quarter, and that was growth of \$9.2 million or 7% over last year. The growth was driven by volume increases across all product groups within the segment. Nutritional Specialty product sales of \$32.6 million grew \$3.4 million or 12% over last year, on volume growth of products for the poultry and dairy industries, in the United States and by penetration into various international markets.

Vaccine sales of \$18.2 million grew \$1.3 million or 7% over last year on volume growth in international markets. Domestic vaccines growth was moderate due to reduced disease pressure in the quarter.

The largest product category in the Animal Health segment is MFAs and other. Sales there were \$82 million in the quarter, a \$4.5 million or 6% increase from last year. Our U.S. sales of MFAs and others declined as we have seen in recent quarters – domestic sales declined \$4.2 million -- \$2.1 million of that decline was due to lower sales of medically important antimicrobials. We also saw some decline due to unfavorable timing of certain customer orders. We believe domestic sales of medically important antimicrobials have stabilized at current levels.

Our international sales of MFAs and others increased \$8.7 million in the quarter due to growth across most regions, notably due to additional penetration into the cattle sector in a number of geographic regions. A recent acquisition also contributed to that sales growth.

Gross profit for the segment increased \$3.9 million. The improvement was due to volume growth, on favorable product mix, higher average selling prices on a few selected products and improved operating efficiencies in our manufacturing processes.

We increased our segment SG&A spending in Animal Health by \$3.8 million. As I said earlier, investing for increased product and organizational development costs; a recent acquisition also contributed to the increase. As a result, adjusted EBITDA was \$35 million for the quarter, that was a \$400,000 or 1% increase and it was due to all of the factors I just talked about above.

Looking at our other segments. Mineral Nutrition had a good quarter -- net sales of almost \$60 million, increased \$2.9 million or 5% from last year, due to favorable product mix and higher commodity pricing. The adjusted EBITDA for that segment was \$5.6 million in the quarter. That was an increase of \$900,000 over last year on the favorable product mix.

Performance Products net sales of \$13.4 million were ahead of last year, but adjusted EBITDA was even with last year on higher product costs. Our corporate expenses of \$8.4 million were level with last year.

Looking briefly at capitalization and capital allocation. Our gross leverage ratio continues to improve. The gross ratio of debt to adjusted EBITDA was 2.6x at December, and we had a \$67 million of cash and short-term investments on the balance sheet at quarter-end.

For the quarter, we reported solid positive cash flow. We reported \$28 million of cash provided from operating and investing activities, excluding the cash used to purchase short-term investments and to complete a business acquisition.

Our operating assets and liabilities, the changes in those assets and liabilities, provided \$8.4 million of cash in the quarter, primarily from the timing of sales and collections in our international business.

We did purchase \$27 million of short-term investments during the quarter, utilizing cash that was previously included in cash and cash equivalents.

During the quarter, we paid the remaining \$3.4 million purchase price related to the acquisition of an Argentine Animal Health business and we paid the routine quarterly dividend in the quarter and have declared the same amount again to be paid in March.

Looking at our updated guidance. We have updated our annual guidance based on our expectations for the remainder of our fiscal year. A full

table of our updated guidance is included in the press release. I summarized some of the lines here. We now expect Animal Health sales to be between \$520 million and \$535 million. That will give us annual growth of 4% to 7%. The updated guidance is an improvement of \$20 million compared with the previous guidance.

Our consolidated sales are now expected to be between \$800 million and \$825 million. That would be annual growth of between 5% and 8%. That's an improvement of \$35 million compared to our previous guidance.

We're now calling for adjusted EBITDA in a range of \$127 million to \$130 million -- annual growth of 6% to 8%. This is an increase in the guidance of \$4 million compared with what we said previously. Finally, adjusted diluted earnings per share are now expected to be between \$1.66 and \$1.71 per share. That's annual growth of 10% to 13%, and this revised EPS guidance does include the benefit of tax reform.

So that's the conclusion of our 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 David Risinger from Morgan Stanley.

**Onusa Chantanapongwanij** - Morgan Stanley, Research Division - Research Associate

Onusa here for David Risinger. I have a couple of questions. Firstly, could you please provide some high-level color on Animal Health revenue growth prospects beyond fiscal year 2018? And secondly, what are the current pricing trends in Animal Health and how do they compare with pricing trends a year ago?

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

It's Jack Bendheim. So we continue to see as we have seen and we've discussed many, many times. A continued increase in the level of business, both in the U.S. and around the world. We just came back from the poultry show last week and we're quite encouraged by most of our customers, talking about increasing their flocks and increasing the level of production. Volumes not taken in the U.S. will end up in the export markets, which are quite strong.

So we're seeing strong growth, both poultry and in other proteins, again both in the U.S. and around the world. Pricing trends for Animal Health products, I think we're seeing some slight increases. There's a lot of noise in the marketplace. But generally, I think we think prices are on the increase, again, both domestically and in the international market. It's hard to put a percentage on it but most of the growth we are seeing, we are projecting, we think will come from volume and not from pricing.

Operator

Our next question comes from Erin Wright from Crédit Suisse.

Unidentified Analyst

This is Charlie on for Erin. How would you plan to utilize your savings from tax reform and what sort of areas are you targeting?

**Richard G. Johnson** - Phibro Animal Health Corporation - CFO



Good morning, Charlie. Yes, this is Dick. I think we're going to keep on doing what we've been doing. We'll look at business development. We'll look at debt paydowns. We'll look at investing internally for developing new sources of growth. So basically, continuing on the same path we've been on, with a little more firepower to finance that.

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Operator

Our next question comes from Tyler Etten from Piper Jaffray.

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**Tyler Lee Etten** - Piper Jaffray Companies, Research Division - Research Analyst

How do you feel about the swine industry and any recent pressure there. Do you see the slight downturn in swine impacting the business?

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

I mean, as we said earlier, the -- when we spoke that our U.S. vaccine business was down, it really came from a healthier swine population. It was less disease pressure this year. I mean, what we see in the swine business and our swine customers is that they are quite strong. And again, as I said in our poultry business, exports from the U.S. to many markets remain quite strong. I mean, the U.S. is a low cost producer, and unless there are regulatory changes for our market, we think that business will continue strong. So we -- from what we see from the market is quite strong.

**Richard G. Johnson** - Phibro Animal Health Corporation - CFO

And then I'm sure you're seeing the same thing with other companies. As you look across the industry, the production levels of the U.S. swine producers are increasing production levels substantially. There's a number of new processing plants, either just put into operation or coming online in the next 12 to 18 months. And there's going to be -- there's going to be a lot more throughput. So basically, that means more potential business for us and because the grower has to keep that animal healthy and there's going to be more animals out there. So there's no question about that.

**Tyler Lee Etten** - Piper Jaffray Companies, Research Division - Research Analyst

And on MFAs, we keep talking about that the MFA business stabilizes on the U.S. side, but we're still seeing impacts. Do you have any idea on where we will start to see more flattish downturns in the U.S. MFA business?

**Richard G. Johnson** - Phibro Animal Health Corporation - CFO

Yes, basically, what we're saying is this December quarter was the last significant major negative comparable and we should -- as we go forward now with the March quarter and after, we should see neutral, plus or minus, comps.

Operator

(Operator Instructions) And our next question comes from Michael Ryskin from Bank of America Merrill Lynch.

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

Following up on the last question a little bit, talking about the stabilization of the medically important antimicrobials in the U.S. Given that your mix on the MFA and other segments have shifted over time, were a little bit away from the MFA, medically important antimicrobials, what's the opportunity for that segment to grow in the U.S. to not just be flat but actually start to see some growth over the next couple of years,

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especially now that you have the low base MIAs as part of that?

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

Talk about the growth on the MFAs side or the growth on the domestic side?

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**Richard G. Johnson** - Phibro Animal Health Corporation - CFO

Domestic MFAs.

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

Domestic side across the entire MFA and other business segment.

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

So I think what we're seeing is sort of flattish business. I think there has been, I mean as you can see as you go shopping for food in the market, I think it's kind of a strong customer trend to raising animal without antibiotics is sort of a trend that hasn't affected the bacteria challenges in this segment. While we see in the U.S. flattish antibiotic MFA and other, we are seeing, as we continue to see strong growth in both our vaccine and nutritional specialties, and we think our nutritional specialties sort of we've been in it. We said earlier, we would typical like last year a few times, we saw how fast the market shifted. The market has shifted and the take up of new product takes a while. The customers need to be shown these products, where we've had millions of animals under test and has been tested and grabbing that data. So we think when we see an increase in the nutritional specialties which is obviously, becoming -- will become a bigger and bigger part of the Animal Health space but as far as U.S. goes, we'll see a flattish on the MFA side. Around the rest of the world, as we see this quarter, we'll keep seeing increases, other countries as they get from noncommercial production to commercial production. We have different registrations around the world for different products and we are seeing a very, very nice uptick, especially in our cattle business. So we -- that trend will continue. So we expect the MFAs to grow around the world, especially. It's going to be flattish in the U.S. but strong growth in Nutritional Specialties this year.

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

And changing topics real quick. You've talked a couple of times, about opportunities for business development. Gross leverage at 2.6x, net debt at closer to essentially 2.1x. Can you talk a little bit about the deals you're pursuing? What are the opportunities there, both for product class, geography and how big are you looking at, how high are you willing to get that leverage up for the right upside?

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

The quick answer is no. But I think for the right asset, we're willing to pay up as long as we would see sort of a very rapid paydown of the debt. So we're looking at different assets, both in the U.S. and the rest of the world. And I would say, we're not targeting a single sector and as we said we acquired a company in Argentina, we'll continue to look both in South America as well as Asia for assets.

Operator

And I am showing no further questions from our phone lines. I would now like to turn the conference over to Richard Johnson for any closing remarks?



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**Richard G. Johnson** - Phibro Animal Health Corporation - CFO

All right, everyone. Thank you for taking the time to listen to the call this morning. And we'll talk again in another 90 days. So take care. Bye now.

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Operator

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

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