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Phibro Animal Health Corporation (PAHC)

Q3 March 2019 Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Phibro Third Quarter Financial Results. (Operator Instructions) I would now like to introduce your host for today's conference, Mr. Richard Johnson, Chief Financial Officer. You may begin.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Thank you, operator, and good morning, everyone. Welcome to Phibro Animal Health earnings call for our third quarter ending in March 2019. On the call today are Jack Bendheim, our Chief Executive Officer; and myself, Richard Johnson, Chief Financial Officer. We'll provide an overview of our quarterly results, and then we'll open the line 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 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 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. 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, we want to 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 including intangible amortization, cost of goods sold, accrued compensation cost, transaction

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cost and accrued interest, and excluding other unusual nonoperational or nonrecurring items, including stock-based compensation. Other income and expenses as separately recorded in the consolidated statement of operations, including foreign currency gains and losses, net, and income tax effects related to those pretax adjustments, and any unusual or nonrecurring income tax items.

Before I get into our review of the financials, let me introduce Jack Bendheim with some introductory comments.

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

Thank you, Dick, and thank you, everyone, for joining us on this call this morning.

As I noted on our press release, this past quarter was a disappointing one for us. We saw some unexpected softness in certain international markets, and we were on the short end of some seasonal program choices made by our customers in the U.S. poultry sector, reacting to disease pressures in light of a warmer than expected winter.

In addition, we continue to see a decline in the domestic dairy sector. The current cycle of decline in the U.S. dairy has lasted longer than any in recent memory. And moving forward, we are changing our approach to this sector as we are now assuming the low milk prices are the new normal. As a result, in the coming months, we will be adjusting our product presentations and our approach to marketing our key products into the segment. Our products for this sector have proven to be strong value to U.S. farmers. And we are confident that the changes we are enacting will give us a return to growth in the U.S. market.

Looking forward, we are entering a period without precedent in the global production of protein. I have made multiple trips to China over the last few months in order to better understand the impact of African Swine Fever. Rabobank recently published an estimate of 30% of herd loss a few days ago, and my personal opinion in that the loss would be much greater than that. The impact on the worldwide protein markets of the loss of 200 million-plus pigs in China is just beginning to be understood.

In the medium term, we expect most of the protein production necessary to try to fill this gap in supply will occur in countries and species where Phibro has a strong market presence. But we do not have anything near full visibility at this time. From a Phibro point of view, we will be severely curtailing our sales to swine product into China in Q4. So as a result of our third quarter results and reduced expectations for our fourth quarter due to African Swine Fever, we are bringing down our full year guidance.

I will now hand this conversation back to Dick as I look forward to your questions at the conclusion of the presentation.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

Thanks, Jack.

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Let's start by reviewing the results for our March 2019 quarter. Consolidated sales were $206 million for the quarter. That was a 2% decline versus the same quarter last year. The revenue decrease was driven by volume declines in Animal Health and Mineral Nutrition. We did have some growth-- volume growth in Performance Products, which partially offset the other declines.

Our Animal Health business was negatively impacted by reduced demands for our products in the domestic poultry sector during the quarter combined with continuing challenges in the domestic dairy business.

Our Mineral Nutrition revenues declined on reduced volumes. However, profitability was comparable to the prior year. We'll get into more detail on the segment results later in the presentation.

Reported net income of $14.8 million was $5 million lower than the prior year due to lower gross profit and an increase in the effective tax rate. Diluted EPS of $0.37 per share for the current quarter was $0.12 below the prior-year period. I'll discuss the adjusted results on the next page, on Page 6.

So let's look at selected line items from the P&L. Adjusted gross profit was down $4.2 million compared with the prior year. As I said, volume declines and unfavorable product mix in our Animal Health business along with reduced volumes in Mineral Nutrition contributed to the lower gross profit. Increased gross profit in the Performance Products segment driven by favorable mix and manufacturing efficiencies partially offset the declines. Adjusted SG&A or operating expenses decreased $700,000 or 2%. We continue to monitor our operating expenses closely and control spending whenever and wherever possible while continuing to make strategic investments on key development projects to position ourselves for future growth. Our adjusted net interest expense increased 6% on higher interest rates and slightly higher debt levels.

The adjusted effective income tax rate was 26.4% for the current quarter, slightly favorable to the rate in the prior year. The reduced federal statutory rate this year compared to last was offset by an unfavorable mix of global taxable income plus the effects of the GILTI provisions in the new tax law. For the 9 months, our effective tax rate was 27.8%.

Now to Page 7 and looking more closely at the Animal Health business. Sales of $129 million declined approximately $3 million or 2% as compared to the prior year. Sales declines were in both the nutritional specialties and vaccines product categories, partially offset by volume growth in MFAs and other. Sales of MFAs and other were about $94 million in the quarter, a $1 million or 1% increase from last year.

International sales volume growth in the Asia Pacific region was partially offset by lower domestic demand in the poultry and swine sectors. While we saw international volume growth in the Asia Pacific region during the quarter, we do expect substantially weaker sales in China going forward as African Swine Fever reduces demand.

Nutritional specialty product sales of $28 million declined about $3 million or 10% from last year due to continued weak dairy industry conditions and lower poultry demand as our domestic poultry customers made seasonal program choices that reduced demand for our products.

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Vaccine sales of $16.9 million declined $1.1 million or 6% from last year. The decline was due to a loss of a domestic distribution agreement earlier in this fiscal year and also turbulent economic conditions that continue to affect certain of our international markets.

Adjusted EBITDA for the segment was $33.2 million. That was a decrease of $3.1 million, or 8%, compared with last year largely due to the decline in sales and decline in gross profit, partially offset by reduced operating expenses.

Gross profit for the Animal Health segment declined $4.5 million due to the volume declines in nutritional specialty and vaccine products and unfavorable product mix. Close control of SG&A spend and reduced incentive compensation partially offset the decline in gross profit and overall segment profitability.

And now looking at our other segments on Page 8. Mineral Nutrition net sales of $60.7 million declined $2.3 million or 4% due to lower volumes, partially offset by a modest increase in selling prices. Segment-adjusted EBITDA of $5.3 million was approximately even with the prior year. We continue to reduce operational spending where appropriate and making progress with optimizing gross profit in a highly competitive pricing environment.

Performance Products net sales of $15.9 million increased $2.2 million on new volume growth in personal care products. Adjusted EBITDA increased $900,000 on the sales increase and also due to favorable gross profit driven by the volume growth along with favorable product mix and some improved manufacturing efficiencies.

Corporate expenses of $9.9 million increased $1.2 million over last year, primarily due to increased business development expenses and also due to the cost of strengthening and testing internal controls over financial reporting.

Now looking at the balance sheet and our capital allocation on Page 9. Our gross leverage ratio of debt to adjusted EBITDA was 2.7x at the end of March, and we had $85 million of cash and short-term investments on the balance sheet at quarter-end. For the quarter, we reported an $8 million source of cash before financing activities, and that $8 million was driven by almost $16 million in cash flow from operating activities while approximately $8 million was used during the quarter for primarily capital investments. We paid a $0.12 a share dividend in March and declared the same level to be paid in June 2019.

Now turning to page 10, and as we described in our press release and Jack made reference to earlier, we have updated our guidance for our fiscal year and reduced our expectations for sales and earnings. We now expect Animal Health sales to be between $529 million and $532 million. That's approximately even with last year. Expectations for consolidated sales are between $828 million and $833 million, up slightly from a year ago. Given the sales decline, adjusted EBITDA is now expected to be in the range of $118 million to $120 million for the year. That's a decline of $9 million to $11 million compared with last year. And as a result, adjusted diluted EPS also declines, now expected to be in the range of $1.50 to $1.55 per share, an 11% to 14% decline.

And looking finally at some of the major factors behind our reduced expectations. Some of the results we saw in our March quarter including in our domestic poultry business where seasonal programs reduced demand, we see a continued decline in the domestic dairy sector. Although our Q3 sales into China were strong on programmed deliveries, we now expect forward sales to be significantly weaker on African Swine Fever.

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And finally, it is uncertain as to timing, but the global production response could be positive for us as we go forward.

So that's the conclusion of our prepared remarks. Operator, if you'd please open the line for questions.

QUESTIONS AND ANSWERS

Operator

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

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

I want to -- I have a couple of quick ones. One, I want to start on your comments on the dairy markets. It's been challenging for a while, but I'm just curious what it was that made you come to the conclusion that this is the new normal and there will be no recovery. Because I think we've been cautiously optimistic that 6 to 12 months down the road, we could see a little bit of an upturn. So what did you see in this quarter that made you change that mindset? And then when you mentioned you're changing your approach to the market, if you could give a little more clarity on that. Does this -- are you talking about changing your current sales methods? Is this discussing future R&D projects and your investment in the nutritional specialties category? Just some more color there.

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

Thanks. So I think after being sort of, and nothing compared to our customers, beaten up for the last 4 or 5 years, we just think the dairy prices and the way the dairy market will produce milk and milk products have changed. So where there were thousands and thousands of small farmers in the U.S., I think this low price has resulted in again thousands of farms closing and those cows moving to much larger farms that have the ability to make money even at these very low dairy prices.

So when that happens, economically, that's a shift. And so I think we will see low dairy prices, as we said earlier, being the new norm and carrying into the future. What that does for us is it will require us to have a different approach to the market because there are fewer dairy farms that will be significant to the production of dairy products in the United States. So we are responding. We're looking to have different presentations of products, different programs. And again, really just sitting around and waiting, "okay, the next quarter, prices are going to be better", will not be a solution. So I think we're attacking -- I think the products and our approach to the market will be successful. We've test-marketed it recently. And so we're optimistic. And again, the amount of dairy cows in the U.S., really doesn't change, it just has shifted from small farms to larger farms and need these different approaches to those markets.

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

Great. I appreciate that Jack. And then I want to follow up on the poultry and swine domestic sales that you mentioned, particularly in the MFAs and other category. You've had really strong growth there for 5 quarters there now, particularly the last couple, 9%, over 13%. I get the sense that you're mentioning with the poultry that this is more of a seasonal change, sort of a temporary phasing of purchases, so we should expect a pretty decent recovery there. Is that right, particularly given your comments on offsetting global demand to respond to ASF?

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

So I think the answer to that is yes and yes. I think we've seen the marketplace -- I mean at the end of the day, we are responding -- our products respond to animal diseases, which is often caused by weather and different conditions. So we were on the wrong side of an early warming in the poultry sector. So it got some of our products that weren't -- used more predominantly in the winter times, in the colder climate. So that is sort of looking at history.

Looking forward, I think while there are some articles and people are starting to focus on African Swine Fever, I think it is such a humongous change. I mean there is so much protein that is going to be missing from China as we go forward. And we haven't seen it. We've seen the opposite as pigs started getting sick in China, the Chinese businesses started slaughtering more pigs and putting more pigs in the market. And that dropped the prices, and that affected everyone around the world.

But I'm sort of a big follower of Christine McCracken from Rabobank. She's been studying this thing very closely. And she sort of feels for the next couple of months, the freezers would be empty and also the cupboards will be empty. There are so many pigs missing in China that the demand, global demand for protein will go up. And it won't be a quick shift from pigs to chicken, but it will -- there will be a shift.

But I think anybody who has the ability and the infrastructure to grow proteins, so whether it's hogs or poultry, aqua, even cattle, and it might even shift to the dairy industry, we'll see increased demand. And increased demand, as we all know, will put increased pressure to raise prices. So I think we're about to see a different business climate than, I think, I've ever seen in my involvement in this industry, which goes back a long time. And I think we're just beginning to see it. It's going to happen quickly. It's not that fast to respond. You can't quickly add a lot more pigs. You can't quickly add a lot more chickens. You've got to build the houses, you need approvals, et cetera, et cetera. But in the U.S., in Brazil, in Argentina, in Europe, we will see increased productions across the board in response to these higher prices.

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

I appreciate all the color there. That was actually going to be my next question, if you could talk in more depth about ASF. You mentioned you visited there a few times in recent months. We've certainly been following it very closely and have had a lot of interest from investors. I'm just curious your thoughts on a year from now, 2 years from now, you mentioned some of the international response in offsetting protein production.

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What -- how long do you see that situation taking to play out? I mean do you think ASF is now going to become endemic in the entire region? And this is just going to be the new status quo for the next 2, 3, 5 years? What's sort of your longer-term vision beyond 2019?

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

So I think that people in the animal health industry are starting to talk about this will be endemic. The problem with African Swine Fever being endemic is the virus is so virulent that, often, pigs don't live past 10 days. So what does it exactly mean being endemic if you have no pigs? It's not like you can live with it. So I think the rest of the world is responding. I mean African Swine Fever is a virus that's been around for 100 years. But most people have responded with very, very good bio-security and managing the virus. There has been, to date, no successful vaccine. And we, like everyone else, are looking at this potential of getting into this vaccine, making this vaccine.

So considering the rest of the world, I think they'll be managing this. China, it's extremely hard for them for various, various reasons to get good bio-security. I mean so many of the pigs are raised in smaller farms or backyard farms. Even in the larger farms, it's just the economics driving the investment in pigs because -- you understand what happened. It's not like -- I mean China raises and consumes 700 million pigs a year. So it's not like 700 million pigs have this virus. It's just that if you're raising pigs at a smaller farm or a midsized farm in China, which basically you have 500 pigs, and one pig has the virus and dies, you then have to killl, nicely put, or kill, the other 499.

So now do you want to then repopulate? Because this is going to happen to you again. And there is no insurance. There is no -- there are no methods. So what's happening in China, people are not willing to repopulate. And that's what's driving this shortage.

And as I said, we call Rabobank often, and she's talking about 30%, 35%. People I see in China are talking about over 50%. So you're talking about that 700 million pigs, and if you take my number, because it's makes easier math for me, 50%, that's 350 million pigs. That's equivalent to all the pigs the rest of the world raise. So you just can't solve this problem. And I think this is going to be with us for a long time. I think, yes, there are a lot of smart people working on a vaccine. Someone will come up with a breakthrough. I hope it's us, but someone will come up with a breakthrough.

But even with all of that, you will not be able to solve this problem for 4, 5, 6, 7 years. And again, in China, they'll do a better bio-security. Everyone will do a little bit here. And there will be protein changes. You'll move from pigs to poultry. You'll move to more aqua. So every little thing is going to help. But the size of the problem or the opportunity, which is always the other side of a problem, is so great that this will be with us for a long time. And I think it's going to have to change how the analysts, like yourself, look at the industry and look at protein production. And I think this is going to be with us for a while, and this is going to have a phenomenal effect on all protein production around the world.

Operator

(Operator Instructions) Okay. That now concludes our Q&A portion of today's conference. 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

Okay. Thanks, everyone, for joining us this morning. We'll talk to you again towards the end of August when we release our full year financial results.
Thanks, and bye now.

Operator

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

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