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**Phibro Animal Health Corporation (PAHC)**

Q2 December 2015 Earnings Call



## CORPORATE PARTICIPANTS

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

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

## CONFERENCE CALL PARTICIPANTS

**Brandon Folkes** *Guggenheim Securities - Analyst*

**Erin Wilson** *Credit Suisse - Analyst*

**Douglas Tsao** *Barclays Capital - Analyst*

**David Risinger** *Morgan Stanley - Analyst*

**Kevin Kedra** *Gabelli & Co. - Analyst*

## 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 may be recorded.

I would now like to turn the conference over to Richard Johnson, Chief Financial Officer. You may begin.

### **Richard Johnson - Phibro Animal Health Corporation - CFO**

Thank you, operator. Good morning, everyone. Welcome to the Phibro Animal Health earnings call for our December 2015 quarter. On the call today, as usual, are Jack Bendheim, our CEO; and myself, the Chief Financial Officer. We'll provide an overview of our quarterly results and then open the lines for your questions.

Before we begin, just let me remind you that the earnings press release and financial tables can be found in 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 in our earnings press release.

And our remarks today will also include references to certain fundamental measures which were not prepared in accordance with Generally Accepted Accounting Principles or US 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 US GAAP measures are included in the tables that accompany the earnings press release.

So with that introduction, I'll turn it over to Jack for some introductory remarks and then come back and talk about the numbers in a bit more detail. So Jack?

### **Jack Bendheim - Phibro Animal Health Corporation - Chairman, President, and CEO**

Thank you, Dick; and thank you all for joining us on this call. As you may be able to tell, I'm participating on this call remotely, as I am attending the European Animal Health Investment Forum in London. I'm here as we continue to be actively looking for investments and acquisition opportunities.

I'm very pleased that this past month we were able to complete the acquisition of MVP. It is rare to find a business and a culture that fits so neatly into what we do. The MVP acquisition is another example of how we have become preferred buyers of businesses that prior to the acquisition we had partnered with. In the case of MVP, the two companies got to know one another in the manufacturing and marketing of the MJPRRS swine vaccine.

Let me add a few more comments on the MVP business. MVP was a privately held developer, manufacturer, and marketer of livestock vaccines, vaccine adjuvants, and other products, based in Omaha, Nebraska. We purchased the assets of this business.

Phibro was MVP's largest single customer. The purchase strengthened Phibro's core animal vaccine business, and it provides new opportunities in a fast-growing segment of the animal health industry. MVP has great people and proven manufacturing capabilities and is an excellent fit that supports our growth initiatives, expands our vaccine business, and adds a platform for future growth.



As reflected in our quarterly results, our strengthening position in vaccines and nutritional specialties is of importance in all markets, but especially the United States. The US market is rapidly moving toward the elimination of using medically important antibiotics for growth promotion due to consumer-driven preferences and compliance with the FDA's December 2016 voluntary guidance timeline.

This shift is leading towards increased reliance on vaccines and nutritional specialties, as reflected in our guidance and reported results, where we continue to see double-digit growth in those categories. Our MFA and other products continue to grow outside the United States.

I'll now turn it back to Dick to review this quarter, and I look forward to your questions after that.

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

Thanks, Jack. So looking at our consolidated results: first, our consolidated sales of almost \$192 million grew about \$3 million or 2%. All of the sales growth was volume-driven, primarily in the animal health segment. We also saw volume growth in the mineral nutrition business. But the volume growth was offset by lower pricing, driven by the lower commodity markets.

So with that \$3 million sales increase, we saw gross profit improve to \$62 million or 32.5% of sales, a \$6 million improvement or 11%. That favorable increase at the gross profit line was driven by volumes and mix. It was driven by improved operating efficiencies at our manufacturing facilities; and we also saw favorable cost of goods, both from the volume effect as well as from favorable currencies, as some of our manufacturing plants are in international locations.

SG&A operating expenses increased overall by about 10% or \$3.5 million, driven primarily by increases in the animal health segment, focused on selling, marketing, and development costs. In addition, we are seeing acquisition-related purchase accounting costs drive a bit of that increase. In addition, corporate expenses were higher this quarter on timing and higher -- some higher organization costs.

Adjusted EBITDA, coming down to that line, increased 14%, so total EBITDA was \$28.4 million. A 14.8% operating ratio -- I think that's the same ratio that we had in our September quarter, better than a \$3 million increase over last year, and a nice increase in terms of the operating margin expansion.

Just to confirm, in our September quarter we made comparisons with last year that excluded vaccine licensing milestone payments. There were none of those revenue items in the December quarter last year, so there's no need to have an adjusted comparison with last year. So these are just compared to reported numbers.

Adjusted diluted EPS was \$0.39 in the quarter, up \$0.04 over last year or 11%. The growth was driven by growth in adjusted EBITDA but tempered somewhat by a slightly higher than usual amount of income taxes, which we report on an adjusted basis, on a cash basis -- just due to timing of certain payments.

Turning over to animal health, within the animal health segment we talk about three product groups. Overall total animal health group, we saw good volume growth, primarily in the nutritional specialties and vaccine categories. The MFA, and other category, was down roughly \$2 million or 2% compared to the same quarter last year. But we saw a 17% growth in nutritional specialties and 10% growth in vaccines. The nutritional specialty products continue to be driven by our dairy focus, but also by the introduction of a poultry product, primarily in the US at this point. And vaccines were driven by volume growth.

For the segment, adjusted EBITDA was over \$32 million, \$4 million better than last year, up 14%. And the operating margin expanded to 26.6%, 280 basis points better than last year, really driven by that gross profit expansion coming from the factors I discussed earlier, partially offset by continued investment in operating expenses.

If we look at other segments, the mineral nutrition business, although it showed flat revenues at the top line, did report improved EBITDA over last year of \$400,000 or a 12% EBITDA increase and an expansion of the operating margin to just north of 7%. So we're seeing -- underlying that, we're seeing good volume growth in the business, reduced pricing driven by commodities; and in the quarter we were able to capture good margins on that increased volume.

Performance products -- not a lot to talk about here. Steady demand. Sales were roughly the same as last year. EBITDA was down slightly from last year. And corporate expenses, about \$8 million versus \$7 million last year, or up close to \$1 million.

Just briefly to look at the balance sheet, capitalization, capital allocation. Our leverage ratio at December was 2.8 times; total debt, \$306 million against a trailing 12 EBITDA of \$111 million. Cash on hand, about \$25 million.

Just a slightly negative cash flow, \$2 million negative cash flow during the quarter before financing, as we continue to invest in business growth. Primarily we put some cash into working capital, and we were -- on our CapEx forecast, as we had a heavy CapEx quarter of \$10 million. And then just routine dividend activity: the same \$0.10 per share dividend was paid in December, and we declared the next dividend to be paid in March.

So with that, that's an overview of the financials. So qw will open it up for questions at this point. Operator, if you would, please?



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## QUESTION AND ANSWER

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### Operator

(Operator Instructions) Brandon Folkes, Guggenheim Securities.

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### Brandon Folkes - Guggenheim Securities - Analyst

I was wondering if you can just talk about the potential for margin upside following the MVP acquisition? And then, secondly, how are you thinking about business development following MVP? What are your priorities? Thank you.

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### Jack Bendheim - Phibro Animal Health Corporation - Chairman, President, and CEO

I think I'll take part of that, anyway. As I sort of mentioned at the start, right now I'm in London. There is a sort of investment conference here today, looking at innovative startups in animal health and animal health and nutrition businesses. So we keep looking for opportunities. I would say generally they will be bolt-on, as they have been in the past. And I think the focus areas are in the growth areas, which is nutritional specialties, which is in vaccines.

And even looking at antibiotics. We continue to see as population grows, as animal numbers grow, and animal disease continues. We continue to see opportunities across the three platforms of our animal health and nutrition business.

I think the first part of the question had to do with margin expansion with MVP. What we've always said is that ultimately we see pretty much same final EBITDA margins across the animal health segments. So we don't expect to see, other than the results of the increased sales, increased margin expansion.

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### Richard Johnson - Phibro Animal Health Corporation - CFO

Brandon, to close the loop on MVP. We have not disclosed the financial parameters of the business. We did say in the press release announcing the acquisition that we fully expect the transaction to be accretive immediately -- accretive on an adjusted basis, taking out the purchase accounting adjustments. And we certainly stand by that.

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### Brandon Folkes - Guggenheim Securities - Analyst

Great, thanks so much.

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### Operator

Erin Wilson, Credit Suisse.

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### Erin Wilson - Credit Suisse - Analyst

Can you elaborate on the key drivers behind the medicinal feed additives business, whether it be regulatory or broader demand changes? And are you surprised by the shifts that you're seeing, at least in the latest quarter? And lastly, what kind of key products would you highlight as being particularly stronger in the quarter or weaker than that MFA segment?

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### Jack Bendheim - Phibro Animal Health Corporation - Chairman, President, and CEO

So I think we have to sort of segment the world. But as an effect to 209 and 213 that we have spoken about so often, we are beginning to see a change in the way producers in the United States are using antibiotics for growth promotion.

As you know that, and as I said earlier, by the end of this year -- by December 2016, producers will not be able to use antibiotics for growth promotion, and that's a label claim. So some people are getting ahead of the curve; some people are getting ahead of the timing, changing formulations. This is nothing new to us. We've been speaking about this for years. We've anticipated this change, which is why we've invested and have begun marketing nutritional specialties.



I mean, the one thing you just need to understand is notwithstanding legislation, and notwithstanding consumer preferences, the bugs remain the same. The bacteria is out there; the animals need to have -- fight off this bacteria to remain healthy, to grow in an economical way; not to be sick; not to cause any problems towards human health.

So the growers, the producers, need products. And we've seen the shift toward more vaccine use, and we're seeing a shift towards more nutritional specialties that, while they don't work as well as antibiotics, they will replace some of the use of antibiotics as growth promoters.

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**Erin Wilson - Credit Suisse - Analyst**

Okay. And then, I guess, how should we think about, then, the quarterly progression of the MFA business and what this world looks like in 2017?

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

It's a little crystal ball. I think we will continue to see what we've begun to see. I don't think it's going to get any faster. We'll see a progression; we'll see a continuing change in the US towards more people adopting dropping the use of antibiotics with the growth promotion labels.

They'll continue to use antibiotics for treatment, for preventing disease and treatment of disease. We'll continue to see that. And we'll continue to see growth in the basic business around the rest of the world.

I mean, again, as the business shifts and as the consumption of meat continues -- poultry and meat continues around the world, we continue to see, again, for treatment of diseases, we will continue to see a growth in MFAs.

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**Erin Wilson - Credit Suisse - Analyst**

Okay, great. And just one last one. Can you speak to the uptake you're seeing in OmniGen in the US and other markets as well? It seems pretty strong.

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

Yes, I think the numbers point to growing strength in our dairy platform as well as our new poultry platform. It's a combination of a bunch of products. We have had a few -- quite a few test farms going right now in China, so we're anticipating starting to make sales there, maybe even in the next quarter.

We're seeing growth in our European expansion that we have spoken about the past. And we continue to see -- notwithstanding a weakened milk price in the United States and the rest of the world, we continue to see strong business in our dairy platform.

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**Erin Wilson - Credit Suisse - Analyst**

Okay great, thanks.

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**Operator**

Douglas Tsao, Barclays.

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**Douglas Tsao - Barclays Capital - Analyst**

Just maybe talk a little bit about some of the dynamics that are driving some of the MFA growth outside of the United States. And obviously it seemed a little weaker in the US. And sort of some of the key drivers in that geography as well, thanks.

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

As I mentioned to Erin, I think that the key drivers for the sort of lack of growth in the United States is changing regulations, and what is that driving in some consumer perceptions of needs and uses. Around the rest of the world, though, as -- you know, it comes back to the basic fundamentals that you've written about and other people have written about, which is growing population, growing well, growing needs of food security, and growing number of animals.



So we're seeing growth in Latin America, South America; we've seen growth in the Far East; we've seen growth in Africa. We are seeing growth in all of these other markets in the world that are putting more animals into a more scientific way, a higher productive way of producing. Because at the end, as we know, there is water shortages; there is scarcities; there is land not growing. So the method that we have produced in the United States for years are expanding across the world, and we're participating in that growth.

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**Douglas Tsao - Barclays Capital - Analyst**

And are there any particular products that are doing particularly well that might be different than what we -- than in the US? And then, as a follow-up, just sort of a commentary. Obviously there's a lot of concern and volatility around emerging markets. Just what you're seeing in terms of the macro environment, accepting that that's probably more of a near-term dynamic than sort of a long-term secular trend?

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

Okay, so basically the bacteria remains pretty much the same, and the antibacterials/antibiotics are used pretty much the same. There are not many products that are permitted to be used in animals. Most of these, as we have said often before, are older antibacterials and antibiotics.

So the quiver hasn't grown. So the same products that have been approved in the United States and approved in Europe in different markets are sold around the world. So we have our suite of products, and we continue to present the same products, depending on applications, depending on disease pressure, et cetera, et cetera.

The emerging markets -- I mean, there is dynamics today, obviously, with the stronger dollar to currencies. But I think quite fundamental to the countries in the world that are growing is the ability -- let's call it just food security. The ability to continue to deliver quality, wholesome protein is as important in China today as it was three years ago. So no matter what's happening with the rest of their business, and other things we read about every day could be changing, it's important to -- the governments of China, the governments in Brazil are coming to all of these markets in the world, which, again, is headlined in the news that the availability of wholesome, quality, inexpensive food continues.

And we are part of that chain; we are a part of that. We provide our product. No one reimburses our customers. They do this in order to produce this quality food we're talking about. It's not -- you know, it's thick and thin, but clearly it would be better if the currencies were stronger. But the business continues to grow.

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**Douglas Tsao - Barclays Capital - Analyst**

Okay, great. Thank you.

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**Operator**

David Risinger, Morgan Stanley.

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**David Risinger - Morgan Stanley - Analyst**

I have, I guess, a couple of questions. First, with respect to the high-level outlook, I think it would be helpful for you to comment on the political noise that's occurred and the reality that you see. It seems like the political noise is overblown, as it typically is. And the reality is that MFAs are safe, because the antibiotics are not used in humans. But I was hoping that you could comment on that.

And then in terms of the financial outlook, I was just hoping for a little bit more color on the outlook for operating cash flow and CapEx going forward; and also how we should think about the March quarter results -- whether there were any anomalies to be aware of with respect to the March quarter results. Thanks very much.

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

Let me take the second part first.

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



Yes, that's what I was saying, Dick. You get the first part, and then I'll take New Hampshire afterwards.

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

So we are not updating our guidance this quarter. So our guidance simply stands as it is out there. I think all of the elements that you called out, David, are in that existing guidance.

For the March quarter, I'm not aware of any anomalies. We did have -- when we do the comparison with last year, our March quarter last year had \$2 million of the one-off milestone revenue and EBITDA in it. So in terms of comparisons, we'll have that against -- in last year as a -- to compare against. But no other anomalies.

Jack, you want take the political versus reality?

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

My version of the primaries. So -- and I don't want to say that politics is overblown; we're a little deep into it. But the reality is that animals are going to get sick. And can you raise an animal without using any drugs? The answer is yes; it's very expensive, and people who have the money and want to spend that money, that's -- there's a market for that.

But if I look at the politics, if I look at what's going on -- take in the United States. Most people in the United States are not earning fortunes, and their salaries haven't gone up. And I think it's important for them to be able to continue to buy healthy, wholesome protein, and not get sick if they go to some fancy restaurants and stuff like that, and who knows what happens.

So I think they'll be -- there's room for all of these decks, and there's definitely room for a combination of antibiotics, antibacterials, nutritional vaccines to keep all the animals healthy. And as I said earlier, we'll get our fair share of that.

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**David Risinger - Morgan Stanley - Analyst**

Got it. Thank you, Jack and Dick.

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

Thank you, David.

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**Operator**

(Operator Instructions) Kevin Kedra, Gabelli.

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**Kevin Kedra - Gabelli & Co. - Analyst**

Just wondering if you could give a bit more quantitative color on the different -- on what you're seeing as far as the decline on the MFA business in the US versus what you're seeing as far as growth internationally?

And then, secondly, just wondering: in the US or globally, are you seeing any movement from competitors, given some of the pressures we're seeing on the MFA business? Are there people looking to actively exit that business or divest certain assets? And could that be an opportunity for you guys?

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

Yes, on the first part, the breakdown. We haven't given any breakdown. We have basically just said that net MFAs were down, a couple million dollars -- \$2 million. And net in there, there was international growth, offset by contraction in the US. So that's really the -- that's what we have talked about.

I think the second part of the question was competitors and what competitors are doing. Jack, do you want to take that?



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

There has been some movement in the MFA space. So we -- I think we feel that we have broader product lines, so we're not looking to add to that product line. And the acquisitions we're looking to do is expanding in the vaccines and nutritional specialties, where we see growth both in the US and in other markets around the world, chances to get into Europe.

And as I said, again, I think we will see over the next few years a stabilizing or stabilization of where antibiotics are in the US and continued growth as the numbers of animals continue to grow across the world.

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**Operator**

Thank you. And I'm showing no further questions at this time. I would now like to turn the call back over to Richard Johnson for any further remarks.

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

All right. Well, we'll just say thank you, then, to everyone. And we'll talk to you again in 90 days. Thanks, bye now.

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**Operator**

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

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