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Phibro Animal Health Corporation (PAHC)

Q2 December 2014 Earnings Call

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Erin Wilson *Bank of America - Analyst*

David Risinger *Morgan Stanley - Analyst*

Irina Koffler *Cantor Fitzgerald - Analyst*

Douglas Tsao *Barclays - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen and welcome to the Phibro second quarter financial results conference call. As a reminder this conference call is being recorded. I would now like to turn the call over to Richard Johnson, Chief Financial Officer. Please begin.

Richard Johnson - *Phibro Animal Health Corp. - CFO*

Thank you, Operator and good afternoon everyone, and welcome to the Phibro Animal Health Corp. earnings call. This is for our fiscal second quarter ending December of 2014. On the call today are Jack Bendheim, our Chief Executive Officer, and myself, Richard Johnson, the Chief Financial Officer. We will provide an overview of our quarterly results and then we will open the lines up for your questions.

Before we begin let me remind you that the earnings press release and financial tables can be found on the Investor section of our website at PAHC.com. We're also providing a simultaneous webcast of today'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. Now our remarks today may 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 we refer you to the forward-looking statements sections in our earnings press release.

In addition our remarks today will also include references to certain financial measures which were not prepared in accordance with Generally Accepted Accounting Principles or US GAAP and we refer you to the non-GAAP financial information section in our earnings press release for a discussion of these measures. Reconciliation of these non-GAAP financial measures to the most directly comparable US GAAP measures are included in the financial tables that accompany the earnings press release. And now here's Jack Bendheim.

Jack Bendheim - *Phibro Animal Health Corp. - CEO, President, Chairman*

Thank you, Dick and thank you everyone for joining us on this call. As Dick will detail in a couple of minutes we had another very solid quarter with double-digit top line expansion in our core Animal Health and Mineral Nutrition businesses and strong consolidated EBITDA growth. This continues to be a great business environment for the animal protein industry, and we are in it to play our part in helping our customers produce healthy and wholesome animal protein products for the world. I'm also extremely excited about our entry into the swine vaccine business through our partnering with MJ Biologics late January.

Those of you who have met with our management team know that our long-term strategic vision is to be agnostic as to what species are produced as well as what means the farmer utilizes to keep his animals healthy and his meat safe. And the entry into the swine vaccine market is another critical step in towards fulfilling that vision. I also think the MJ Biologics partnership is yet another example of Phibro's willingness to help the owners of smaller Animal Health companies with unique offerings to fulfill their vision of growing their business before exiting.

Like we have already done with a number of products in the dairy nutritional specialty markets, and are in the beginning stage in the aquaculture space, we envision helping MJ Biologics expand their portfolio of products and geographical presence prior to our eventual purchase of the business. This approach benefits both Phibro and the sellers as we believe we are unique among our competitors in having a history of successfully implementing deals of this sort. I will now turn it back to Dick to give a little more color on our second quarter.



Richard Johnson - Phibro Animal Health Corp. - CFO

Thanks, Jack. Turning to page five of the presentation, walking you through the consolidated results for our December quarter, our December sales were approximately \$189 million, that's about \$16 million of sales growth, or 9% overall. The table shows it broken down by segment, our Animal Health segment grew almost \$11 million or 10% over the prior year.

Mineral Nutrition business had another strong quarter with \$8 million of sales growth, 16% over the prior year, and our Performance Products business was down about \$3 million compared to last year. Gross profit improved 10% on the 9% sales growth performance, and most of that gross profit growth obviously was due to the sales growth, most of it volume related with some selected pricing actions. I did mean to say that on the sales line for the 9% sales growth the bulk of that growth was volume related. There was a smaller effect due to pricing, but largely volume driven.

At the SG&A line about \$36 million of SG&A. Just over \$2 million increase over the prior year or about 6% as we invested monies in our Animal Health segment and we also saw an increase in our corporate expenses as we transitioned to being a public company. That's where really all of that year-over-year dollar increase came from on the operating expense line.

Coming down to adjusted EBITDA, \$25 million of adjusted EBITDA in the quarter. \$2.7 million of growth over the prior year, or 12%, as we saw that sales growth was leveraged both at the gross profit line and at the operating expense line giving us that EBITDA increase of 12%. On an adjusted diluted EPS basis \$0.35 of EPS, in the quarter.

So now if I turn to the Animal Health segment on page six, and drilling down a little more on Animal Health, Animal Health sales overall were about \$119 million of sales. Close to \$11 million of sales growth or 10%. The biggest part of the Animal Health segment, MFAs and other, grew better than \$7 million or 9% over last year. Nutritional Specialties had another strong quarter of growth, growing better than \$4 million or 27% over last year. And vaccines at \$10.6 million. That's a pretty consistent number on a run rate basis. However, it was down from the year before largely on a volume decrease due to some international registration delays compared to last year. Overall, again, most of the 10% sales increase in the Animal Health segment was due to volume growth. Adjusted EBITDA grew 15% as we had good leverage and operating improvement both at the gross profit line and moderate operating expense investment behind our growth initiatives gave us a 15% adjusted EBITDA increase and brought our operating margin for the quarter to 23.8%, better than a hundred basis point improvement over the same quarter last year.

Looking at our other segments on page seven, as I said, Mineral Nutrition had another strong quarter. This is really three quarters in a row now where we have seen substantial growth and profit improvement in this business. It's primarily volume driven. Some of it is pricing driven by underlying commodity pricing as happens in this business, but largely volumes are driven by increased demand and as demand has increased we have been able, to a certain extent, to expand our margins. So you see our margin 6.4% of sales, up compared to last year by 70 basis points and that over 6% margin comparable with what we have been doing now for the last three quarters, including this quarter.

Performance Products were about \$11 million of sales in the quarter, down \$3 million from last year. Reduced industrial demand in the quarter saw sales soft compared to last year, primarily volume related. Also some reduction in the sales line was due to the effects of underlying commodity pricing which also pulled sales down somewhat. As a result of the sales decline, adjusted EBITDA of \$200,000 was down, in line with the sales decline from last year.

Corporate expenses for the quarter were just over \$7 million, up \$1 million over last year. Really driven by the effect of the public company costs, as a result of our IPO, so we're still overlapping quarters where we had a lower corporate expense base.

So then if I turn to capitalization and capital allocation, at December 31 our balance sheet was such that we had a 2.8 times leverage ratio, \$289 million of total debt, fundamentally the term B loan, as we were undrawn on our revolver, and had a very insignificant amount of capital leases outstanding and compared against our \$102 million of trailing 12 month adjusted EBITDA. We closed the quarter with \$21 million of cash-on-hand. We generated roughly \$5 million of net cash flow before financing for the quarter. Used that cash flow to fund the quarterly dividend payment and to fund some scheduled debt reduction that you see on the slides there, about \$3.9 million for the dividend and \$800,000 for the debt reduction. And then as we announced yesterday, we have declared a regular quarterly dividend for the same amount, \$0.10 per share, that will be payable on March 25th of 2015.

So that's the end of my prepared comments. Operator, so if you would open it up, please, for questions?

QUESTION AND ANSWER

Operator

Louise Chen - Guggenheim - Analyst

Hi. Thanks for taking my questions. I had a few. First question I had was on your MJ Biologicals vaccine agreement. Just curious if you would give more color where -- what stage of development these products are in and what the peak sales potential of these products will be and just maybe why vaccines are interesting. We've seen a lot of animal health companies move towards them. So just curious what is the growth opportunity there?

And then secondly with respect to your volume growth, looks like it was robust, and curious if you could characterize how much of that was US, how much of that was outside the US, if you have seen any slow down at all in volume growth outside the US. And then lastly in terms of business development, where are you seeing the best opportunities, you know, what type of areas in animal health, what types of drugs, is it diagnostics or what have you. Thanks a lot.

Jack Bendheim - Phibro Animal Health Corp. - CEO, President, Chairman

So why vaccines? Generally vaccines are preventing diseases, and they are widely used and with the growing population of animals, vaccines clearly is a space that everyone in animal health area really wants to get into. And it's not easy to enter this space. The regulatory, capital, intellectual property is quite high, so I think we were quite fortuitous in developing this relationship, this partnership with MJ Biologicals. I mean it gets us into the swine vaccine business.

As you know out of our Israeli sub we are in the poultry vaccine business internationally, and in the United States on the poultry side we have this arrangement with Epitopix where we are selling both salmonella and e-coli vaccines into the breeder and growing in the layer industry. But the swine industry is a very, very large business in the United States. Everyone is well aware. One of the exciting things about this acquisition -- about this arrangement that will be an acquisition in 2020, is the work they're doing on developing a PEDs vaccine. There was a quick article about that in the New York Times a few months ago and it's in the development stage. So various diseases affecting swine are of interest to us. It's way too early for us to put a dollar amount on the market opportunities or our percentage of it, but it's something that we're really excited about.

Richard Johnson - Phibro Animal Health Corp. - CFO

Yes. Just one other piece to your question there, Louise. One of the agreements we signed with them is a distribution agreement and we are distributing their current product line. So they have a product in the market, it's out there, it's already in commercialization, your question asked what stage were they at. They have a product that is commercialized and has been for some time. And then in addition as Jack talked about there's development opportunities that we're excited about both in the US and perhaps internationally for expanding our range of vaccines to other diseases. Other applications.

Yes. Let me take the second question of yours and that was on volumes. I would say in our Animal Health business where we're doing business outside of the US we're seeing good volume demand. Your question was are we seeing a slowdown in some of the international markets and -- and on balance certainly not. We're seeing good, strong demand in the international markets and, in fact, a good part of our growth in the quarter I think we called out was due to growth in the international market.

Certainly that's true in the MFA business. In the nutritional business it's more the case where we're still primarily a US business, but we're seeing a good pickup in demand in the select international markets that we have entered in that product category also. So international is going well. And then I think the third piece of your question was business development, what do we see. Yes. That's -- you know, we're always looking -- Jack, do you have any other comments on that?

Jack Bendheim - Phibro Animal Health Corp. - CEO, President, Chairman

I think we're always looking. There's nothing imminent and, you know, if anyone on this call has some ideas we are happy to take them.

Louise Chen - Guggenheim - Analyst

Thank you.

Operator

Erin Wilson - Bank of America - Analyst

Great. Thanks for taking my questions. So are you reiterating guidance here and what does your guidance incorporate as far as fundamental demand trends, foreign currency fluctuations, and any sort of commentary you can give on how we should think about the tax rate over the next few quarters. Thanks.

Richard Johnson - Phibro Animal Health Corp. - CFO

Yes. We're not updating our guidance at all, Erin. So the guidance that we put out there stands at this point. So that would imply that the tax rate -- as I recall I talked about roughly a 20% cash tax rate for the year. We're probably running slightly below that, but we're not updating our guidance at this point. Foreign exchange, as we have said in the past most of our sales outside the US tend to be with reference to dollars and so we're not directly impacted as some other businesses are where sales are set in local currency. Clearly, at the margin, our products could become too expensive, but we don't see foreign exchange seriously changing our sales trends in the near-term.

Erin Wilson - Bank of America - Analyst

Okay. Thanks. And can you speak to the approval of OmniGen in China, and that potential opportunity and how that should ramp over time? And also do you still expect that \$2 million milestone payment later in the year?

On vaccines?

Richard Johnson - Phibro Animal Health Corp. - CFO

On the milestone payment, right. It's in our guidance and we still expect it, yes.

Jack Bendheim - Phibro Animal Health Corp. - CEO, President, Chairman

And as we had said, we received the approval of registration for OmniGen in China. We have lined up a distribution agreement with a major Chinese animal health company and they're in the process of hiring sales people to call directly on the larger dairies as well as on the distribution chain over there. And we're ramping up with our own people in China. So it's too early to put any numbers on it, but overall as we all know and from what we have read that China is a big growing demand for dairy products, and commercially I think they're looking to end up with something like 5 million head which will be -- that's a potentially very large market for us.

Erin Wilson - Bank of America - Analyst

Okay. Great. Thanks so much.

Operator

David Risinger - Morgan Stanley - Analyst

Yes. Thanks very much. Hi Jack and Dick. So I've got a couple of questions. I guess first with respect to the MJ Biologics deal, I was hoping that you could just frame for us how we should think about the initial revenue opportunity annually for Phibro and the longer-term opportunity just so that we -- you know, we have a sense for whether we should think about it being -- I don't know -- I will throw out numbers, you know, a -- a \$1 million revenue opportunity in two years or a \$20 million revenue opportunity in two years? You know, any sort of framework would be helpful. And then, Dick, in terms of the next quarter, so the March quarter sequentially any color you could provide so that we have a sense for any anomalies or any inflections in the business that we should be aware of when we're modeling the March quarter relative to the March quarter of 2014.

Jack Bendheim - Phibro Animal Health Corp. - CEO, President, Chairman

Great try, David. We're not comfortable yet. We are way too early in the MB Biologics business to really put out any numbers at all. As Dick said, they have some sales, very, very small sales. We're just getting our sales force acquainted with these products. I mean this is something that we will be much smarter about and talk a lot better about it in future quarters but for right now, as Dick said we're not changing our guidance. We're very thrilled to be in this segment. It is a big segment, it has lots of competitors. So it's way too early to say how we're going to do, but we will do our best to make an impact.

David Risinger - Morgan Stanley - Analyst

Okay. Great.

Richard Johnson - Phibro Animal Health Corp. - CFO

On your other question on trends, anomalies, inflection points, we don't see anything different from the ordinary course of business. We see some of our products, may have more demand or less demand depending on disease pressure, depending on other factors, but we don't -- I don't see anything in terms of an anomaly or -- or an inflection point one way or the other, looking into the March quarter. We will get this final \$2 million milestone payment either in the March quarter or the June quarter, but that will be a discrete item. It will be set out. You will see that separately.



David Risinger - Morgan Stanley - Analyst

All right. Great. Well, congrats on the strong performance. Thank you very much.

Richard Johnson - Phibro Animal Health Corp. - CFO

Thank you.

Operator

Irina Koffler - Cantor Fitzgerald - Analyst

Hi. Thanks for taking my question. You mentioned that there was international product registration delays in your vaccine business. Did these delays persist into third quarter as in this quarter and how much additional revenue can be generated once these agreements come through?

Jack Bendheim - Phibro Animal Health Corp. - CEO, President, Chairman

When you are dealing with registrations it's impossible to predict when they will finally come through, so I can't say it's going to happen in this quarter or next quarter, but we fully expect to get the registrations. And again once you get the registrations you have to hope the disease pressure is there and you go back in the market so it's hard to put a dollar amount on it as well.

You know, overall it was done as somewhat of an explanation of why we're flat or slightly down year-on-year and then something else generally in our business, our vaccine business is pretty much a non US -- except for the points I made before, a non-US business. So the effect where our sales in these countries were dollar based and the currencies had devalued around the world, you know, it will put some pressure on us as Dick said earlier making our products maybe a bit more expensive than a locally produced product.

Irina Koffler - Cantor Fitzgerald - Analyst

And these delays are not impacting your guidance because you are still maintaining that, right?

Jack Bendheim - Phibro Animal Health Corp. - CEO, President, Chairman

Correct.

Irina Koffler - Cantor Fitzgerald - Analyst

Okay. Thanks.

Operator

Douglas Tsao - Barclays - Analyst

Hi, guys.

Richard Johnson - Phibro Animal Health Corp. - CFO

Yes. Go ahead.

Douglas Tsao - Barclays - Analyst

Sorry about that. Going back to the MJ Biologics I mean how do we think about the initial opportunity first in swine? Is there an expansion of the portfolio over time that you anticipate, you know, sort of contributing?

Jack Bendheim - Phibro Animal Health Corp. - CEO, President, Chairman

Well, I think what we bring to the mix is a larger sales force calling on the US swine industry than MJ Biologics currently has. So as I said earlier as we train our sales people and we get out there, I think we'll see some increased market penetration. As we work with their development people and our development people we are going to look for opportunities to take some of this technology, move it overseas into markets where there is a big swine population and where these products, these vaccines can be effective, and then we will continue to look into developing new vaccines. Currently they are in the section called PRRS, we spoke about the article in the Times where they're working on a PEDs vaccine, and we will continue looking at other vaccine opportunities both in the US and around the world.

Douglas Tsao - Barclays - Analyst

Okay. Great. Thank you.

Operator

Thank you. There are no further questions in queue at this time. I will turn the call back over for closing remarks.

Richard Johnson - Phibro Animal Health Corp. - CFO

All right. Well, we'll just say thank you to everyone and look forward to talking to you again in 90 days. So that's it. Have a good day. Bye now.

Operator

Thank you. Ladies and gentlemen, this concludes today's conference. You may now disconnect. Good day.

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