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Phibro Animal Health Corporation (PAHC)

Q4 June 2016 Earnings Call

CORPORATE PARTICIPANTS

Richard Johnson *Phibro Animal Health Corporation - CFO*

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

CONFERENCE CALL PARTICIPANTS

Brandon Folkes *Guggenheim Securities - Analyst*

David Risinger *Morgan Stanley - Analyst*

Erin Wilson *Credit Suisse - Analyst*

Kevin Kedra *Gabelli & Co. - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Phibro Animal Health Corporation fourth-quarter financial results conference call. (Operator Instructions)

I would like to introduce your host for today's conference, Mr. Richard Johnson, Chief Financial Officer. Sir, please go ahead.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Thank you, operator, and good morning, everyone. Welcome to the Phibro Animal Health Corporation earnings call for our fiscal fourth-quarter ended June 2016 and it's also the end of our fiscal year.

On the call today with me is Jack Bendheim, CEO. We will provide an overview of our quarterly and annual results and our guidance for our FY17. And then we will 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 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.

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. 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 financial tables that accompany the earnings press release.

With that introduction then, let me turn it over to Jack Bendheim for some introductory remarks. Jack?

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

Thank you, Dick, and thank you all for dialing in this morning. We have just completed our FY16 and our outlook for 2017 is to be a year of transitions.

The US markets are moving away from various uses of antibiotics and we have positioned ourselves to benefit from these moves by adding vaccines and nutritional specialties to our portfolio. Like life, all transitions are not smooth, but we are trending in the right direction, albeit slower than we would have wanted to see. We remain very bullish about our industry, our customers, and these trends to increase protein consumption. Phibro is benefiting from these trends in the US and around the world and we're looking forward to increasing our performance as the new year progresses.

That's my very short remarks and we will talk a little bit later as we get to Q&A. Back to you, Dick.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Thanks, Jack. As Jack was talking about just briefly in the animal health update, this is just an update of what we said when we talked about our March results that some US producers are reducing antibacterial usage. Phibro's current annual sales of medically-important antibacterials was $37 million at June of 2016.

On the other side and on the positive side, we've seen continued international volume growth of MFAs and we are seeing very nice double-digit growth, both in our nutritional specialty portfolio as well as vaccines. In part because producers are looking for alternatives to maintain the health of their animals.

Now looking at Q4 results on a consolidated basis. Consolidated sales were up 2% in the quarter year over year -- that's about $4 million of sales growth -- driven by volume growth in the animal health segment. Mineral nutrition sales were below the prior year, and we will get into that in a moment, and performance products were up slightly year over year.

At the gross profit line, gross profit was, on a reported basis, down 1%. On an adjusted basis it was up 2%, driven by volumes. We did see negatives in the quarter from the idle capacity cost of the production interruptions from upgrading our good manufacturing practices, GMP, in our vaccine plant. So that hit the gross profit line in the quarter. We do continue to see operating efficiencies in many of our production facilities.

SG&A, on a reported basis, was up 1%, about $0.5 million, and it was really due largely to accruals in our performance products segment as well as some increased corporate costs. Adjusted EBITDA was up 4%, or just over $1 million, to $28 million in total. That was an improvement in the operating ratio to 14.9% compared to 14.6% a year ago.

And then coming down to adjusted diluted EPS, $0.40 for the quarter. That was down $0.04, or 9%, from a year earlier. The growth in adjusted EBITDA was offset by increased depreciation expense, interest expense, and higher income taxes year over year. And there's a footnote at the bottom there that tells you, in detail, what adjustments we make to the GAAP numbers.

Looking at page 6, animal health. Animal health sales, the segment sales, increased almost $9 million, or 7%, driven by volume growth across all of the product portfolio, all of our product groups.

MFAs rose 3%, or $2 million -- that was international growth in Brazil and other international markets -- offset by reductions in the US. Nutritional specialties were up 14% year over year in the quarter. That was driven by volume growth in our products for the US dairy and poultry industries. And vaccines were up 29%, better than $3 million in growth, as we saw volume growth there across our product lines as well as the benefit of the MVP acquisition.

At the adjusted EBITDA line, animal health segment was $31.5 million of EBITDA, $1.6 million increase year over year, or 5%. We saw the growth of sales drop down through with some negatives at gross profit due to the manufacturing cost that I talked about a moment ago, and we saw flat operating expenses in the segment for the quarter.

Looking at page 7, other segments. Mineral nutrition, about $50 million of sales in the quarter, down roughly $5 million, or 9%, from a year earlier. Most of that top line decrease was related to commodity pricing. There were also slightly reduced volumes just on seasonal variations. However, at the adjusted EBITDA line, despite the revenue decline, we saw adjusted EBITDA increase $200,000, or 5%, as we were able to make up most of that margin shortfall or sales shortfall either with margin improvement or favorable operating expenses.

Performance products sales increased $800,000; however, adjusted EBITDA was down slightly, $100,000 from a year earlier. And we saw the operating margin decline on some increased accruals in the business. Corporate expense were $7.2 million, a $0.5 million increase over the prior year.

So turning just briefly now to the full year, fiscal year of June 2016. Reported sales -- so in 2015 -- we say this in the footnote at the bottom -- we had $8 million of milestone payments related to the licensing of some vaccine delivery technology. So we have made the comparisons excluding that $8 million in the prior-year numbers to give a better sense of the trends of the business.

So excluding that, sales overall increased almost $11 million, or 1%. In the animal health segment we saw $23 million increase, or 5%, and that really is all on volume growth. Mineral nutrition, top line revenues decreased $10 million for the full year related to commodity pricing and full year the performance products segment was reduced by about $2 million.

If we look at the gross profit line, 31.8% of sales on a reported basis, a 6% increase year over year. On an adjusted basis, gross profit was up 8%. The gross profit improvement was driven by volumes and mix, by improved operating efficiencies, and favorable cost of goods from volumes and from currencies over the course of the year.

SG&A overall, again on a reported basis, about a 5% increase; on an adjusted basis about a 4% increase. And driven by investments in the animal health segment in the selling, marketing, and development areas, as well as some increases in corporate costs.

Adjusted EBITDA was $114 million this year compared to $102 million last year, which excludes the $8 million of licensing income, so that's a 12% increase just driven by all of the factors that I just discussed. And an improvement in the operating margin overall to 15.2% for the year.

On a full-year basis, adjusted diluted EPS was $1.61. That's up 6% from a year earlier. The growth in adjusted EBITDA was partially offset by increased depreciation, interest, and income taxes for that net interest.

Looking at page 9, the capitalization and capital allocation. We continue to improve our leverage ratio. It was 3.1 times at June 30 with $353 million of total debt against $114 million of adjusted EBITDA.

We had $34 million of cash on the balance sheet at June 30. Cash flow during the June quarter was a $19 million source of cash and routine quarterly dividends $3.9 million paid in June and the same amount declared to be paid in September.

So now turning to guidance on page 10, let's just walk down the table first. Within our overall consolidated sales we've broken out net sales for the animal health segment and we expect animal health segment sales for our FY17 to be between $495 million and $510 million. And that would be 2% to 5% growth over the comparable number for 2016.

Total net sales we are expecting to be $750 million to $770 million. That's flat to up 2% over the prior year. Adjusted EBITDA, expectations are to be between $116 million and $120 million. Again, 2% to 5% growth over the prior year. And that would mean our operating margin ratio would be 15.5% to 15.6%, roughly a 30 basis point improvement year over year.

Adjusted EPS -- and this is comparable year over year with a new or revised method of adjusted income taxes, so we will get to that in a moment. But adjusted EPS of $1.38 to $1.45 compared to $1.43 for 2016, so that's somewhere between a 3% decline and a 1% increase.

Then if I just walk through the bullets below the table. Within that animal health segment in the overall 2% to 5% growth, we expect the nutritional specialties and vaccine product categories will continue to grow at double-digit rates and MFAs and others will be between stable to a single-digit decline for the year.

Mineral nutrition revenues are expected to decline slightly as we continue to expect volume growth, but see some year-over-year continued effect of reduced commodity pricing. And performance product revenues are expected to be stable or decline slightly. At the gross profit line, we expect an improved gross profit ratio due to favorable business and product mix.

Adjusted EBITDA will exclude the cost of a partial settlement of the pension plan, which could be up to as much as $3 million. We are offering a lump sum window to certain participants in the pension plan. In addition, there will also be the same recurring adjustments to exclude acquisition-related items and foreign currency gains and losses.

So turning to the provision for income taxes and the effective tax rate, we expect our effective tax rate to be 29.5% through 2017, essentially the same as the revised adjusted effective rate for 2016. We've revised our reporting methodology to now present the GAAP provision for income taxes adjusted for the tax effect of any pretax income adjustments and also to remove any nonrecurring or discrete items. For example, in 2016 we had a significant benefit from the release of valuation allowance, mostly around the net operating losses.

We revised our methodology in part to reflect recent SEC guidance on presentation of non-GAAP measures, which prescribes use of cash income taxes as a profitability measure. So when you look at adjusted diluted EPS, the growth in adjusted EBITDA is largely -- it's really completely offset by increased depreciation expense and interest expense, so that's why growth in adjusted EPS is fairly modest.

On a quarterly basis, we expect our quarterly results will grow at similar rates as our full-year expectations with lower growth rates earlier in the year and increased growth rates later in the year.

Looking at cash flows, we expect to generate positive cash flows after satisfying our needs for working capital, capital expenditures, dividends, and special debt repayments. CapEx is expected to be in the $30 million area. And, finally, we remain interested in acquisitions and any positive cash flow could support potential acquisition activity.

That's the end of my formal remarks, so with that, operator, if you would open it up for questions, please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Brandon Folkes, Guggenheim Securities.

Brandon Folkes - *Guggenheim Securities - Analyst*

I just had three. The first one, do you think you can replace the full $37 million with alternative products in your portfolio? And if so, how long do you feel this transition would take?

Secondly, just on vaccines. Can you update us on the progress of winning back potential business lost during the upgrade of the vaccines plant? And then lastly, if you can just talk about pricing potential in 2017 and what you assume in your guidance. Thank you.

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

Thank you. So the first question, first of all we don't anticipate all $37 million of going away. As we are trying to say, the market has been shifting and adjusting. You've read some reports on some poultry producers who are marketing to different segments and clearly what's happening here is consumer-driven -- consumer preferences.

Also, consumers are willing to pay the much higher prices that will entail for producing mostly poultry without the benefits of these certain antibiotics, i.e., they're going to see more diseases and see more disease pressure. They will manage it, but they will manage it with various other kinds of products. So to that point, we definitely anticipate whatever drops we see over the course and that's why I said earlier it's a transition time.

It doesn't happen in a day, but I think over the course of this coming fiscal year we fully anticipate to completely, dollar wise, replace any lost sales we've had in the US in various antibiotics with other kinds of products, whether it's vaccines, whether it's nutritional specialties, whether it's other antibacterials that don't come under the guidance of 152. So we remain optimistic and we are already seeing -- we are doing business today with some companies who have moved in this direction earlier and we are doing more business with them today than we have done three or four years ago. So that is to one.

The interruptions we had when we took our Israeli plant through GMP had affected us, affected us in the last year. In fact, even going into this quarter. It's like anything, you disappointed a customer; we will get the business back. It will be with concessions and, again, it won't happen immediately because you have to regain their trust. But we remain optimistic that we will regain market share in the markets we lost and grow from there.

Finally --.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Your question was on pricing, Brandon, and I would say our guidance for 2017 has very modest or minimal pricing assumptions in it. So as we are talking about sales, we are really talking about volume growth. There may be individual products or markets where we will take some pricing actions, but that's not the driver of the business.

Brandon Folkes - *Guggenheim Securities - Analyst*

Great, thanks very much.

Operator

David Risinger, Morgan Stanley.

David Risinger - *Morgan Stanley - Analyst*

Thanks very much. Good morning, guys. I have a couple questions, please.

First, with respect to the negative impact of some of your customers moving away from MFAs, could you just quantify how much of a negative impact you expect in your 2017 guidance as the result of that? Also, if you could just discuss the cash flow outlook for 2017 and, finally, how we should think about the September quarter sequentially, relative to the June quarter results that you just recorded? Thanks so much.

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

Thank you, David. It's good to hear your voice. We think the market is still working out for itself where they are going to come out on antibiotics. This trend, which we've spoken about, initially was driven by the movement away from antibiotics' use for growth promotion. Sort of the blanket use of antibiotics to prevent diseases.

The market is definitely staying, and most of our customers I think, volume wise, will stay, with the use of antibiotics with treatment. So it's moving because we are not sure yet. We haven't gone through a full cycle and cycles, depending on quality of feed, depending on climate, depending on so many other things where you have disease pressures.

So this business is not going to disappear and every customer is going to be changed; it's not going to be so formulistic. And the practices are changing as we go forward.

So I think overall we will end up, by the end of the year, our -- unless we're mostly talking about poultry. Our overall poultry segment, our estimation is that our business this coming year will be larger than our business this past year. It will be made up of different products through the cycle.

To the cash flow --.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Our cash flow outlook for 2017 is positive. I don't have a more definitive number than that I can give you, but I think it basically says we will have moderate use of working capital after. And I think you see that in our June quarter, where we had a good quarter on working capital performance. Not indicating that that's going to continue for all of next year, but that's more directionally where we expect to be.

We've given you CapEx, so cash income taxes and interest expense will be in line with where we've been running, but I don't have an overall number to talk to you about.

And then the third point was the September quarter sequentially. I will go back to what we said in our guidance is that we expect our quarters to see the same growth rates as we have forecast for the full year with slower growth starting out the year. So I would say our September quarter is going to be at the slower end of those guidance growth rates we've put out there for the full-year numbers.

David Risinger - *Morgan Stanley - Analyst*

Got it, thanks very much.

Operator

Erin Wilson, Credit Suisse.

Erin Wilson - *Credit Suisse - Analyst*

Great, thanks for taking my questions. You mentioned strength in the international MFA business. What geographies are you seeing that sort of strength and what's driving that strength? Thanks.

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

Thanks, Erin. The geography we're seeing is around the world. So it's true in South America, Latin America. We are seeing it in the Far East. We are seeing it in China. We are seeing it in Eastern Europe. We are seeing it in Africa.

So we are seeing it in all markets around the world as -- again, in places where we have growing population or you have countries that want to control their own food sources and not totally rely on imports. As they get into these businesses and as they start moving -- and you've heard this story many times -- they start moving to higher productive methods of raising animals. Then they have the ability, because then they have the vets and they have the nutritionists, to basically see what's going on, see the diseases, and try to prevent the diseases.

So that is a trend we've spoken about for a long time and those are trends we see continuing around the world. As Dick mentioned earlier, overall for our fiscal year ending in June, our kilos, our pounds sold of overall MFAs were higher than they were the year before, but we've seen shifts. And the shift in the United States, as we've spoken about, is more driven by the consumer and then it's driven by the needs, by the market needs.

Obviously, we are a consumer-driven market and we'll respond to that. Again, for Phibro it's going to be fine.

Erin Wilson - *Credit Suisse - Analyst*

Okay, great. Then from a regulatory standpoint, how far along is the industry in adopting the new FDA regulations that will -- the ones that will go into effect I guess in 2017? What percentage of your customer base has already converted to the new standards and what's left as we assess that trend on a go-forward basis?

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

I think it's basically done. I think that the customers -- the law goes into effect January 1; no one is going to wait until sometime after Christmas to get it done. Everyone is moving in that direction, so everyone will be in compliance.

But I would say we already are seeing across the country, no use -- I wouldn't say no, but I'm talking about plus 90% use of antibiotics for growth promotion. So I think most of the customers across the species we sell into have already made the move. We're way past the regulatory side and now we're into, as I said earlier, consumer preferences.

Erin Wilson - *Credit Suisse - Analyst*

Right, right, okay. And then (multiple speakers).

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Erin, that $37 million number includes -- it would include any regulatory risk as well as consumer-driven products. So it's the same set of products; it's both factors. They are not -- the dollars aren't separate. They are all included in that $37 million.

Erin Wilson - *Credit Suisse - Analyst*

Okay, great. Then can you -- speaking to some of the offsets here, can you speak to some of the traction you are seeing on the poultry nutritional specialty product as well as OmniGen?

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

I would say -- the dairy industry in the United States, really the dairy industry around the world, is coming off a very, very difficult couple of years. Most of them have been losing money. I think that's starting to end, so we will see growth going forward both in the US and in our export markets in the use of OmniGen.

And some of the reflection we've seen already is the shifting by US poultry consumers, poultry producers from the use of antibiotics to control diseases to try to control these same diseases with nutritional specialties, trying to get different attributes out of a healthier animal. And, subsequently, we benefit from a line of our products.

Erin Wilson - *Credit Suisse - Analyst*

Okay, great. One quick last one. Just can you speak to the capacity for acquisitions, what you were looking at and are you potentially targeting also partnerships, licensing deals similar to what you have also done in the past? Thanks.

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

The partnership idea works well for us. It allows us to lower some of the risks in terms that we make sure that the products work well. It allows us to -- not to overstretch in terms of leverage. And I think that has always been our preference -- continues to be our preference in looking at acquisitions.

Erin Wilson - *Credit Suisse - Analyst*

Great, thank you.

Operator

Kevin Kedra, Gabelli.

Kevin Kedra - *Gabelli & Co. - Analyst*

Thanks for taking the questions. I hopped on a little late, so I wasn't sure if you guys mentioned anything about carbadox, any update there, and what is built in to your outlook for that product.

And then secondly, we are seeing some signs of possibly a return of the H5N2 avian flu. Just wanted to get a sense of, if we were to see an outbreak of that again, what kind of impact that might have on your business going forward.

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

Those are two great questions. And no one had asked that before.

So on the carbodox, as I'm sure you read, we -- within the timeframe, we responded to NOOH and we've sent in all of our comments. And as we have stated, we had completed the studies that were most likely the reasons for the NOOH, because we had not -- it'd taken us a long time to get these studies in because it was a very, very complicated test method and we had to sort of create effectively the science, which we did using university partners overseas.

We have now done all those things and I think we are currently being reviewed by the FDA and there is no timetable. They can take a long time to review it. They can come back and they could tell us they want to proceed.

The average -- if they proceed to a hearing, it could take a couple years. Sometimes it's taken as long as four years to get to the hearings. It is very, very resource-intensive; not just for us, but also for the Agency.

So in the meanwhile, we continue selling the product. We can continue selling the product; the product is an extremely important product. And sort of in a crazy way -- and we talked some on this call about antibiotics -- the removal of this product will cause the increased use of antibiotics. So it's quite strange.

But, anyway, that's where we are and I don't think we have any more information about that.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

We have said that this product is a $15 million product and, as Jack said, we continue to -- our customers continue to buy the product, need the product. So, going forward, that's our expectation until we know something.

And the other one was avian flu.

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

Avian flu, I mean we all read, as you just read, about this virulent strain that they found in some ducks somewhere. You just don't know. What we saw a few years ago when it hit, it hit in a very, very aggressive way in Minnesota in the turkey industry and then down to Illinois and to the egg industry. It did not hit any of the broiler customers.

So, clearly, pathway is important; biosecurity is important. Since that outbreak two years ago, people have beefed up their biosecurity so it's not easy to tell what, if anything, would be the effect of it if it would hit. But it is something that the US producers, everyone remains very, very vigilant about and we hope it hits somebody else

Kevin Kedra - *Gabelli & Co. - Analyst*

All right, thanks.

Operator

I'm showing no further questions in queue at this time. I would like to turn the call back to Mr. Johnson for closing remarks.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

All right, everyone. Thanks for taking the time to listen in this morning. We will be back talking to you in early November with our first-quarter results, so until then, take care. Bye.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program and you may now disconnect. Everyone, have a great day.