

February 7, 2017

Phibro Animal Health Corporation (PAHC)

Q2 December 2016 Earnings Call



CORPORATE PARTICIPANTS

Jack Bendheim *Phibro - President, CEO*

Richard Johnson *Phibro - CFO*

CONFERENCE CALL PARTICIPANTS

Brandon Folkes *Guggenheim - Analyst*

Tyler Etten *Piper Jaffray - Analyst*

Kevin Kedra *Gabelli - Analyst*

Erin Wright *Credit Suisse - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Phibro second quarter financial results call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will be given at that time. (Operator Instructions). I would now like to turn the call over to Richard Johnson. You may begin.

Richard Johnson - Phibro - CFO

Thank you, operator. Good morning, everyone, and welcome to Phibro Animal Health earnings call for our second quarter ended December 2016. On the call today are Jack Bendheim, our Chief Financial [sic] Officer, and myself, Richard Johnson. I'm the Chief Financial Officer.

Jack Bendheim - Phibro - President, CEO

The two of us.

Richard Johnson - Phibro - CFO

The two of us. We will provide an overview of our quarterly results and then we'll open the line for your questions.

So before we begin, the standard reminders. Let me remind you that the earnings press release and financial tables can be found on the Investors section of our Web site at pahc.com. We're also providing a simultaneous webcast of the morning's call, which can be accessed on the Web site as well. Today's presentation slides and a replay and transcript of the call will also be available on the Web site 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 on 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.

So now let me turn to page four of the webcast and review the consolidated -- oh, sorry. Now let me turn it over to Jack Bendheim for some introductory comments. My bad.



Jack Bendheim - *Phibro - President, CEO*

Thanks, Dick. It's early here in New York. Thank you all for joining us on this call. As I note in my statement and our earnings release last night, I am very pleased with how our business performed in the December quarter, and in particular the positive momentum in sales growth in our US Animal Health business. As most of you are aware, beginning January 1, 2017, the US animal health and ag community, in partnership with the FDA, has voluntarily given up the use of medically important antibiotics for growth promotion use, though these products remain available for therapeutic uses.

While the rule's change only went into effect on January 1, we saw most of our customers implementing these changes throughout the second half of calendar 2016. Still, due to the strength of our nutritional specialties and vaccine offerings, we were able to grow our US Animal Health business in the face of these guidelines as well as the continuing industry response to consumer preferences. Our momentum in the industry is strong as Phibro is increasingly being recognized as the leader in product offerings for animals raised without antibiotics, in addition to our leadership in products for conventionally raised animals.

Overall, our core Animal Health business grew 2% top line and adjusted EBITDA grew 7% as the strength of our US business more than offset weakness we continued to see in the Brazil economy, as well as the global dairy market. We have seen some pickup of late in milk pricing, although the Brazilian agriculture economy continues to struggle due to the combination of currency, input costs, and reduced domestic demand. If this recovery in the dairy industry holds, we are well positioned to benefit with our dairy offerings in the US and overseas as well as we accelerate on nutritional product rollouts.

I will now hand it back to Dick to go through the numbers in greater detail. I look forward to taking your questions following his review.

Richard Johnson - *Phibro - CFO*

Thanks, Jack. So now on to page four for the consolidated results for the December quarter. Consolidated sales were \$192 million for the quarter. That was a slight decrease versus the same quarter last year. The decrease was driven by lower commodity pricing in the Mineral Nutrition segment, while we did see volume growth and revenue growth in the Animal Health segment.

Our gross profit was 33.1% of sales and that was an improvement of 110 basis points compared with last year, a \$2 million, or a 3% improvement over last year. The improvement was due to favorable business and product mix, to volume growth, to lower raw material costs and improved operating efficiencies, as we continued to see the benefit of recent CapEx investments.

And looking at selling, general, and administrative expense, on a GAAP basis that line increased \$2 million or 5%. However, the current year included \$1.7 million of costs related to the partial settlement of our domestic pension plan. We've excluded these costs from adjusted EBITDA as a one-time item consistent with our practice of excluding certain items we consider to be unusual or nonrecurring. Excluding that pension settlement cost, SG&A increased about \$300,000 or 1% over the prior year. The increase was principally driven by higher business development costs that are included in the corporate piece of our business.

So dropping down to adjusted EBITDA -- adjusted EBITDA was \$31.2 million for the quarter, a \$2.8 million or 10% increase over the prior year, as all segments of the company contributed to the improvement.

And then at the adjusted diluted EPS line, we reported \$0.39 per share for the quarter, a \$0.02 increase or 5% growth over the prior year. The improvement in adjusted EPS was driven by the growth in adjusted EBITDA, partially offset by increased depreciation expense and a higher effective income tax rate.

Now turning to page five and looking more closely at the Animal Health business -- sales of approximately \$124 million grew more than \$2 million, or 2% over last year. The growth was driven by very nice double-digit increases in the nutritional specialty and vaccine product categories, offset by a decline in the MFAs and other category.



Nutritional specialty product sales of \$29 million grew \$5 million or 21% over the last year on volume growth of products, primarily for the US poultry and dairy industries. Vaccine sales of \$17 million grew over \$5 million, or 45% over the prior year, on volume growth across the product portfolio, and included products acquired from MVP about a year ago in January of 2016.

Sales of MFAs and others were around \$78 million in the quarter, a decline of about \$8 million or 9% compared to last year. We saw reduced sales of medically important antibacterials in the US. However, we did see growth in other domestic products that are included in this category. We saw international volume declines due to challenging economic conditions in Brazil as well as the timing of orders in certain other markets.

The Animal Health sales growth and favorable gross profit and modest increase in operating expenses resulted in a segment adjusted EBITDA of \$34.6 million for the quarter, an increase in excess of \$2 million or 7% over the last year. So a good quarter and a good profit increase in the Animal Health segment.

Turning to page six and looking at the other segments. Mineral Nutrition net sales of approximately \$57 million declined about \$2 million or 4% from last year, primarily due to lower commodity pricing. Despite the revenue decline, adjusted EBITDA for the segment increased to \$4.7 million, an increase of approximately \$600,000 over last year on the benefits of lower raw material costs and also reduced operating expenses compared to the prior year.

Performance Products net sales of approximately \$11 million were slightly below last year, but favorable product mix and input costs contributed to a \$300,000 improvement in adjusted EBITDA. Corporate expenses of \$8.4 million increased \$300,000 year-on-year as I said earlier mostly on increased business development costs.

Now looking briefly at capitalization, capital allocation, the balance sheet and cash flow -- our leverage ratio at December was 2.8x based on total debt in principal amount of \$331 million and trailing EBITDA for the 12 months ended December of about \$119 million. At the same time, we had \$39 million of cash on the balance sheet.

We continued to have another nice quarter of cash flow generation. We generated \$21 million of net cash flow before financing. We saw favorable working capital in the quarter. And in addition, our CapEx has been running behind our forecast, so we're seeing the benefit of slower CapEx spending.

Dividends, we paid a routine quarterly dividend in the quarter and have declared the same amount per share to be paid in March. And then finally, looking at guidance, we've reaffirmed our annual financial guidance that we presented in our August press release. The guidance is repeated in this webcast simply for your convenience.

And that's the conclusion of my prepared remarks. So operator, if you'd now please open the line for questions. Thank you.

QUESTIONS AND ANSWERS

Operator

Yes. (Operator Instructions). Our first question comes from Brandon Folkes of Guggenheim Securities. Your line is open.

Brandon Folkes - Guggenheim - Analyst

Hi, guys. Congratulations on another good quarter. Can you give us some color into what the pushes and pulls could be in the second half of the year? Just reaffirming guidance is great, but given the performance in the first half of the year, I think there was potential to take up at least the low end.



And then secondly, can you talk about what is driving the volume growth in nutritional specialties and vaccines? Was there any discounting or stocking in the quarter? Thank you.

Jack Bendheim - *Phibro - President, CEO*

Let me take the second -- it's Jack. Hi, Brandon. Thank you. Second first. I think the volume growth is basically being established by our positioning and the work we've done these last few years of creating products that will help our customers as they, as the consumer demand has moved away from products that have contained antibiotics. As we've always said, the animals remain sick or the animals can get sick and you need to help the animals do things that will allow them to be stronger to sort of fight off diseases. None of these things work as well as antibiotics but we need to respond to consumer demand. So we've increased our portfolio of product in nutritional and vaccines and we're seeing the market grow. So we've done a very, very good job.

As I think I said before, we did not expect this to move as fast as it moved in the consumer side. We obviously expected it to, the changeover that we spoke about on January 1 on the regulatory side. And I think we're very, very well positioned to continue our growth. And obviously it's always easier to look backwards but as we look ahead, the next six months or into the future, I think we're very well positioned to have the necessary products to allow our customers to grow into this market sphere. Why we haven't changed the guidance, I'd give it to Dick for the hard one.

Richard Johnson - *Phibro - CFO*

Yes, first kind of one follow-up to that. It's kind of a technical question at the end. I forgot the term you used. But there was no --

Jack Bendheim - *Phibro - President, CEO*

I think the technical term is loading.

Richard Johnson - *Phibro - CFO*

There were no order pattern changes, so this reflects what the animals are eating. There's no inventory push or pull here. On guidance, I think -- we've been running well this year. There's still a number of unknowns, so we're being cautious on the second half of our year. I think that's where we're at on guidance.

Brandon Folkes - *Guggenheim - Analyst*

Okay, great. And then maybe just one follow up on business development. It looks like you remain active. What are you seeing there that's preventing you from getting over the line in transactions? Is it still pricing of deals or what is it? Thank you.

Jack Bendheim - *Phibro - President, CEO*

So as you see from the capital sheet, we're increasing our ability to do deals. So it's not lack of resources. What we're seeing is really pricing is that assets throughout the classes of what the businesses we're in, whether it's vaccines or nutritional, antibacterials, antibiotics -- all remain very, very high, a lot higher than our parent stock. So we want to be cautious. We just don't want to literally overspend but we continue to look. And the acquisitions we've done in the past are sometimes a bit complicated. In order that we can buy more reasonably, it causes us to work a lot harder. But we remain interested in growing the business both organically as well as by acquisition.

Brandon Folkes - *Guggenheim - Analyst*

Great. Thanks very much and congratulations again on managing this transition so well. Thank you.

Jack Bendheim - *Phibro - President, CEO*

Thank you.

Richard Johnson - *Phibro - CFO*

Thank you, Brandon.

Operator

Our next question comes from Brett Wong of Piper Jaffray. Your line is open.

Tyler Etten - *Piper Jaffray - Analyst*

Hi, guys. This is Tyler Etten on for Brett. Thanks for taking my question and good morning.

I was wondering if we could talk about Brazil a bit. So what kind of challenges are you seeing in that region, considering we've been hearing more favorable sentiment out of the region? And I guess what is your outlook for the remainder of the year out of Brazil, or what potential direction it could go?

Jack Bendheim - *Phibro - President, CEO*

So first of all, congratulations on a win on Sunday.

Tyler Etten - *Piper Jaffray - Analyst*

Thank you.

Jack Bendheim - *Phibro - President, CEO*

I'm surprised you're on the phone. I imagine that's why Brett's out on the road.

Richard Johnson - *Phibro - CFO*

He's still in Boston, right?

Tyler Etten - *Piper Jaffray - Analyst*

Yes.



Jack Bendheim - *Phibro - President, CEO*

Anyway. Brazil has had a -- getting back to the business, Brazil has had as we all know and gone through a lot of political and economic crisis in the last year, particularly in the ag industry. Due to weather challenges, they lost a corn crop. Now Brazil, unlike the US, has two corn crops a year which gives them a unique ability to have cheap input costs. They didn't get a lot of rain last year. They did get it this year. So last year the price of corn in Brazil was 2x to 3x higher than the rest of the world. And they can't easily make up for it by importing corn because of port congestion, infrastructure, et cetera, et cetera. So they had a difficult year in terms of input costs as well as currency and the local economy. So domestic consumption in Brazil was down. Export markets were harder to do, because of their high input costs.

That's getting better now. Again, they had the second crop, so we think it will return. But that's basically been the driver and if you see it's true for everybody selling for the ag market in Brazil. This is across the board. This is a problem we've all faced this year, last year.

Richard Johnson - *Phibro - CFO*

We continue to be very bullish on the Brazil market. It's an ag powerhouse in many ways, but we're being cautious as to when the protein producers will start to see their demand pick up and therefore drive our demand.

Tyler Etten - *Piper Jaffray - Analyst*

Got it, thanks. That's very helpful. Okay, maybe shifting to the US, specifically the cattle industry -- obviously, margins have compressed this year. Just your thoughts around the cycle as we move through the year and if you've seen any consumer shifts in what they're purchasing?

Jack Bendheim - *Phibro - President, CEO*

The cattle business in the US is not a huge segment for us. It's an important segment, and more on the minerals side. I think we're seeing more animals on feedlots. I think they're think they're staying on feedlots longer. And just what we're hearing in the trade arena, I think they expect to have a decent year in business. And I can't get really -- we are not that close to that industry to give you much more in depth.

Tyler Etten - *Piper Jaffray - Analyst*

Okay. And then my follow-up question was going to be and how it compares to the swine market?

Jack Bendheim - *Phibro - President, CEO*

I think the swine market remains strong. Exports remain very, very strong. China, which is overall the largest importer around the world of swine, have kept their numbers down. So they continue to import. They do shift that around whether to import from the US or from other markets. But China remains a very, very strong market and overall our hog industry is growing and people are putting on more animals in the United States. So we expect that business to continue growing positively.

Tyler Etten - *Piper Jaffray - Analyst*

Great. Thanks. And then just one more, if I can sneak it in. Just your thoughts around when the MFA comps would get easier considering we saw the shift away from the products faster than usual. Just which quarter do you think it would start to flatten out? And that should be all from me. Thanks.



Richard Johnson - *Phibro - CFO*

Yes, I think the comps are going to be negative on the domestic side and the comps are going to be negative, certainly through June and possibly through September, but somewhere in that range. We'll see negative year-over-year comps.

Tyler Etten - *Piper Jaffray - Analyst*

Great. Thanks, guys.

Operator

Our next question comes from Kevin Kedra of Gabelli. Your line is open.

Kevin Kedra - *Gabelli - Analyst*

Thanks for taking the question. I wanted to ask if you're seeing any shifts in the market given some of the larger consolidation we've seen among some of your larger peers. And then on the guidance, I know you mentioned that it's basically taking a conservative approach, but I did want to nitpick on the interest expense line. Just your guidance at \$17 million is certainly above kind of where you're trending. Is that just a continued conservative look or is there something there we should be thinking about as far as your cash and debt?

Richard Johnson - *Phibro - CFO*

So on the guidance piece, we've had cash flow better than we expected this year. So we're seeing interest running below guidance. So I think what we're running net interest year-to-date is probably what we're going to run the rest of the year. So we'll be favorable on that line of the P&L. On the competitive landscape, I'll let Jack comment.

Jack Bendheim - *Phibro - President, CEO*

So I think the consolidation we've seen have been a lot more on the companion animal side. I think that's been the driver. There's been some shift and when you consolidate and you do change ownership of the production animal side, but it hasn't really done a lot to sort of get rid of competition. So I think competition remains, as always, fierce. But again, we're an industry that's driven by population, wealth, and production growth, and we continue to see that. We continue to see that in the US. We continue to see that around the world. So the unknown out there I'd say in the poultry side is the avian Influenza which moves product production around but ultimately the consumption around the world of all these proteins continues to grow.

Operator

(Operator Instructions). Our next question comes from Erin Wright of Credit Suisse. Your line is open.

Erin Wright - *Credit Suisse - Analyst*

Great. Thanks for taking my questions. Can you speak to the demand trends in dairy both in the US and globally?

Richard Johnson - *Phibro - CFO*

I think the global dairy industry has seen pricing recover recently. Pricing in the US for fluid milk was as low as in the \$13 and change range. It's now up to between \$16 and \$17. So at \$13, dairymen were losing money. At the current rate, they're making some money. They're back, they're certainly back on the black. It's not the bonanza they had when milk was up into the low \$20 range a year or two, a couple of years ago. So we are seeing improved demand for our products in the dairy industry and in the markets we serve, which are primarily the US and there's some select international markets where we're expanding. So I think the dairy industry is, it's not out of the woods yet completely but better than it has been in the recent past.

Erin Wright - *Credit Suisse - Analyst*

Okay, great. And then how should we think about the quarterly progression of the vaccine business as we wrap MVP contributions here in the coming quarter?

Richard Johnson - *Phibro - CFO*

I think we continue to see double-digit sales growth. It won't be the 45% of -- I can tell you it won't be the 45% of the December quarter but it will -- we'll continue to have double digit top line growth in vaccines.

Erin Wright - *Credit Suisse - Analyst*

And what's driving that in terms of kind of species group? Is it swine versus poultry and kind of what are some of the underlying demand trends that you're seeing across that business? Thanks.

Richard Johnson - *Phibro - CFO*

Yes, it's both those species. Our vaccine portfolio is fundamentally to those two species, poultry and swine. And we've got a good portfolio of products and we're out there selling more volume both in the US and in a number of international markets.

Jack Bendheim - *Phibro - President, CEO*

I think that's exactly right. I think we also and this is something that we've worked on for years and sort of thought about in terms of product development as well as production. When you remove antibiotics -- the general use of antibiotics from whether it's the chicken house or from the swine barns, there were also diseases people are seeing. So there is an increased demand and there's a preference on the consumer side to see vaccines. So we think we're well placed to sort of satisfy some of this demand both with our US vaccine business and with our overseas vaccine business.

Sorry, and the last little point is that remember we had stopped production in our Israel Beit Shemesh plant in order to upgrade our manufacturing processes. So we were shut down for a while, so that overlap we're seeing will continue as we go ahead over the next -- well definitely for this year and into next year as well.

Richard Johnson - *Phibro - CFO*

Yes, we had somewhat depressed sales because of supply constraints in the second half of last year, of our last year, our last fiscal.



Erin Wright - Credit Suisse - Analyst

Okay, great. Thank you so much.

Operator

There are no further questions. I'd like to turn the call over to Richard Johnson for any closing remarks.

Richard Johnson - Phibro - CFO

All right, everyone, thank you for joining us this morning. And we'll talk again in another 90 days. Take care. Bye now.

Operator

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

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