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Phibro Animal Health Corporation (PAHC)

Q3 March 2017 Earnings Call

CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

Brett William Sprinces Wong *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Erin Elizabeth Wilson *Crédit Suisse AG, Research Division - Director and Senior Equity Research Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Phibro Animal Health Corporation Third Quarter Financial Results Conference Call. (Operator Instructions) As a reminder, this call is being recorded.

I would now like to introduce your host for today's conference, Mr. Richard Johnson, CFO. Sir, you may begin.

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

Thank you, operator. Good morning, everyone. Welcome to the Phibro Animal Health earnings call for our third quarter ending March 2017. On the call today, as usual, are Jack Bendheim, our Chief Executive Officer; and myself, Richard Johnson, Chief Financial Officer. We'll provide an overview of our quarterly results, and then we'll open the line for your questions.

Before we begin, just the standard reminder that the earnings press release and financial tables can be found on the Investors section of our website at pahc.com. We're also providing a simultaneous webcast of this morning's call, which can be accessed on the webcast 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 on our earnings press release.

Our remarks today will also include references to certain financial measures, which were not prepared in accordance with generally accepted accounting principles or U.S. GAAP. I refer you to the Non-GAAP Financial Information section on our earnings press release for a discussion of these measures. Reconciliation of these non-GAAP financial measures to the most directly comparable U.S. GAAP measures are included in the financial tables that accompany the earnings press release.

And now here is Jack Bendheim with some introductory comments.

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

Thank you, Dick, and thank you, everyone who is joining us this morning. As you saw in our press release, our core Animal Health segment showed modest sales growth for the quarter. Double-digit increases on nutritional specialties and vaccine products were the drivers of the segment growth. These products have shown double-digit increases every quarter this year. The MFA and other category declined 7% as we saw ongoing reductions in the United States sales in medically important antibiotics as the U.S. industry fully implemented the voluntary guidance with regard to these products. We also saw continued cyclical weaknesses in our Brazilian markets, but we saw growth in other products and regions within this category.



We made the decision to bulk up on our investments in both product development and organizational capabilities for the Animal Health segment, which reduced profitability in the quarter. While we continue to actively seek business development opportunities, the current valuations for many of the available assets make a build-versus-buy model increasingly compelling.

I also want to recognize the efforts of our Mineral Nutrition team, who are continuing to build share while delivering improved profitability. We believe we have the opportunity to leverage the capabilities of our Mineral Nutrition business and incorporate some of our high-value products, improving efficiencies for our customers.

I will now turn it back to Dick and look forward to answering your questions at the conclusion of this presentation.

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

Thanks, Jack. So on Page 4, just a reminder before we get into the numbers, we do present our results on both a GAAP basis and also on an adjusted basis. Our adjusted results exclude various items, including acquisition-related items, things like intangible amortization, inventory step-up on a purchase, accrued compensation costs, transaction costs and accrued interest. We also exclude unusual nonoperational or nonrecurring items, things like the pension settlement cost or gain on insurance settlement that have happened during our current fiscal year. Also excluded are some other income or expense items, notably foreign currency gains and losses, which mostly arise from intercompany transactions and intercompany balances, and then also the income tax effects related to the pretax adjustments and any unusual or nonrecurring income tax items.

So on Page 5, let's first review the highlights for our March 2017 quarter. Our consolidated sales were almost \$190 million for the quarter, a 3% increase compared to the same quarter last year. The increase was driven by volume growth in the Animal Health segment and volume growth and commodity pricing in the Mineral Nutrition segment.

GAAP results included a \$7.5 million gain on an insurance settlement. We reached the settlement of our claims under our liability insurance policies for damages that we incurred a number of years ago. We previously recognized in our financials the cost of the damages. GAAP results also benefited in the quarter from a reduced provision for income taxes due to a \$3.8 million release of a valuation allowance related to certain foreign operations. And in addition, the GAAP income tax provision included a \$1.4 million benefit related to the exercise of employee stock options.

Our adjusted results exclude -- among the other items, exclude the insurance settlement gain and the favorable tax items.

Our adjusted EBITDA was \$29.7 million for the quarter, even with the prior year. I will discuss the segment performance in the coming slides. And adjusted diluted EPS was \$0.37 a share, a \$0.03 decrease or 8% below last year. Compared to last year, increased depreciation expense and a higher effective income tax rates were the primary reasons for the decline. Our effective income tax rate this year was 28.7%, about 2.6 percentage points above last year.

On Page 6, we present selected line items from our results. Looking at adjusted gross profit. Adjusted gross profit increased by \$300,000 or 1%. One of the reasons for the relatively low growth in gross profit was the depreciation expense increased \$1 million year-over-year and pulled down the gross profit number.

On the adjusted SG&A line, adjusted SG&A increased \$1.3 million in total, fundamentally due to a \$1.6 million increase in the Animal Health segment. To position ourselves for future growth, we increased spending in the segment on product development and organization capabilities.

On Page 7, looking more closely at the Animal Health business. Sales in the segment of \$121 million grew \$2.6 million or 2% over last year. The growth was driven by double-digit increases in the nutritional specialties and vaccine product groups, offset by a decline in MFAs and other. Nutritional specialty product sales of \$27.6 million grew \$4.8 million or 21% over last year on volume growth of products for the U.S. poultry and dairy industries. Vaccine sales of \$17 million grew \$3.9 million or 30% over last year on volume growth across most of the product portfolio.



Sales of MFAs and others were approximately \$76 million in the quarter, a \$6 million or 7% decrease from last year. We saw reduced sales of medically important antibacterials in the U.S. due to regulatory and consumer preference factors. We saw sales decline in Brazil resulting from challenging economic conditions. We did have sales growth of other products in the category that partially offset the declines.

Adjusted EBITDA of \$31.8 million for the quarter decreased \$300,000 or 1% compared to last year. Gross profit growth was offset by increased operating expenses for new product development and organization capabilities.

On Page 8, looking briefly at our other segments. Mineral Nutrition net sales of approximately \$57 million increased \$4 million or 8% from last year due to volume growth and to higher commodity pricing. Segment adjusted EBITDA of \$4.3 million was an increase of \$300,000 over last year, in line with the sales growth.

Performance Products net sales of approximately \$12 million were slightly below last year, but favorable product mix and input costs kept adjusted EBITDA approximately even. And corporate expenses at \$6.9 million decreased slightly year-over-year.

On Page 9, looking at our capitalization and capital allocation. Our leverage ratio continued to improve, and the ratio of trailing 12 adjusted EBITDA to total debt was 2.6x at March 31, 2017. Our positive cash flow continues to improve the leverage ratio. We also had \$49 million of cash on the balance sheet at quarter end.

For the quarter, we generated \$31 million of net cash flow before financing. In addition to generating cash from earnings, we also benefited from a \$7 million favorable working capital and other sources of cash and a \$7.5 million benefit from the cash received from the insurance settlement. We invested \$6.4 million in CapEx and other investing activities, broadly consistent with recent trends. We paid a routine quarterly dividend in the quarter and have declared the same amount to be paid in June.

And on Page 10, looking at our guidance. We have updated our annual financial guidance. The updated guidance on both a GAAP and an adjusted basis is presented in detail in the press release. We now forecast Animal Health net sales in the range of \$490 million to \$495 million, a 1% to 2% increase over last year. We see consolidated net sales at \$760 million to \$765 million, also a 1% to 2% increase. And we forecast adjusted EBITDA in the range of \$118 million to \$120 million, a 4% to 5% increase.

So that's the conclusion of my prepared remarks. Operator, if you would please open the line for questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Brett Wong with Piper Jaffray.

Brett William Sprinces Wong - Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst

First, on the guidance, can you provide a little more color on the breakdown of sales growth in Animal Health? Should we expect similar strength in vaccines that we've seen in the past couple of quarters? And since we're coming up on easier comps for MFAs, granted I know you've talked about their being impacted in June, if not into September, but should we start to see some improved growth there? And also, if you can talk to any preliminary thoughts around what type of growth we could see for the next fiscal year, that would be helpful.

Richard G. Johnson - Phibro Animal Health Corporation - CFO

I would say broadly, our expectation for the remainder of the year is a continuation of the trends we've seen so far this year, Brett. So double-digit growth in nutritional specialties and vaccines and continued decline in the MFA and other category, averaging out to, give or take, neutral to



slightly positive growth, certainly positive growth for the full year. And looking ahead, we're in the middle of our budget discussions and reviews, so I think it's a little premature for us to be talking about next year. We'll put out guidance in late August when we announce our annual financial results.

Brett William Sprinces Wong - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Okay, that's helpful, Dick. And talking about Brazil and the weakness that you keep seeing there, I know that you've previously talked about that really being driven by input costs. But we've seen grain prices falling significantly there. And so just wondering if you're continuing to see the pressure or if you've seen some improvement here just recently and if you can just talk to your expectations in Brazil given lower feed costs.

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

Right, I mean -- it's Jack, Brett. Thank you for asking the questions. We are beginning to see sort of the -- I think we've seen the bottom. We're starting to see some of the increases reflected by the input costs having now come down. I mean, it was pretty dramatic. They lost a planting. So corn prices were very, very high. I think it's come back down now. Business is getting better. I mean, the overall economy in Brazil is not getting a lot better, so consumption of a lot of protein has been down in country, but exports are starting to pick up. I mean, they lost sales with a higher input cost. They're starting to regain those sales. So I think we are going to see better results in Brazil in the coming quarter and continuing better results for the coming year. As we all know, Brazil is an extremely important factor in the worldwide protein markets.

Brett William Sprinces Wong - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Excellent. And then looking at the dairy market, we're seeing some pressure in the U.S. dairy industry just due to some tariffs that have been put in place in North America, stressing trade. And granted prices are still up year-over-year and we have seen a recent lift, do you expect to see any weakness there with ongoing pressures, potentially with more trade issues?

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

So I think that the bigger factor has been pricing. The low price for milk and most derivatives has continued a lot longer than everyone has hoped for. I think it hasn't declined. So we're starting -- again, as things sort of stabilize, I think our customers are feeling better when we start seeing some growth. I mean, clearly, trade restrictions anywhere in the world affect the whole protein market, not just the milk, not just the dairy, it's across every industry. So I think we hope that our leaders get this right, and we don't go into various trade wars.

Brett William Sprinces Wong - *Piper Jaffray Companies, Research Division - Principal and Senior Research Analyst*

Yes, of course, a lot's still to be seen there, huh? Last question from me. I just wanted to talk to the M&A landscape. You mentioned in your prepared remarks that valuations support more build versus buy. Can you just provide more color around that? Have you seen multiples actually getting higher and expanding recently? Or could they just continue to stay elevated near previous levels? And anything that you have been looking at, has any of that gotten more attractive here recently?

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

I don't want to call out various deals that have been recently done. But I mean, you're in the business, there have been various deals that we've seen done that have gone at relatively high multiples of sales, which clearly values our business a lot higher than you guys are currently valuing it. But on a going-forward basis, it's making us, as I said in the prepared remarks, decide to spend more money internally developing products and sales capabilities than acquiring it. So in answer to -- so the long answer to the question, yes, we see valuations continuing to increase in this business.



Operator

And our next question comes from Erin Wright with Crédit Suisse.

Erin Elizabeth Wilson - Crédit Suisse AG, Research Division - Director and Senior Equity Research Analyst

Given what seems to be a little more pronounced decline in Animal Health in the fourth quarter implied in your guidance, what does this mean in terms of what you're seeing with the FDA guidance implementation as well as the consumer-driven pressures as it relates to the MFA business? Is this incremental to maybe what your initial expectations were?

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

So I think -- Erin, thanks for the question. I think what we've seen and what we're continuing to see is the guidance has put a lot more focus on use of antibiotic in the United States. And there is a repositioning among our customers of their product offerings, and this is sort of being worked out as we speak. So we're seeing in the marketplace some customers who are using products or raising animals that we'll call no antibiotics ever. There are customers who are raising animals with no human antibiotics, only animal-only antibiotics. We're seeing customers who are using these traditional methods of raising animals. And their markets are segmented also, a lot to do with what their consumers are prepared to pay. So that's being worked out. Besides that, this is all happening at a time when there's normal cycles in this business. I mean, every different weather pattern, I mean, we've always seen taking the chicken industry, as you know, so well. And basically, the turnover happens every 4 to 6 weeks. So we have to see this year play out and just get into a really -- to understand exactly what everyone is doing and how everyone is doing it in the various cycles. So our business has always been different quarter-to-quarter. This is being worked at the overlay now as these new demand and new uses of products, our customers have to see if this works. I mean, different weather, different times of the year creates different demands, different disease patterns. I mean, what we have to all remember is we're in a business of supplying products that treat animals that are sick. And again, animals get sick differently depending on weather. I mean, this past winter, we saw not a very heavy winter, so we saw a drop in demand for some of our PRRS products because the pigs weren't as sick as they were a year before. So that is -- so that's the overlay we've been seeing. On top of it, as you know, we've been introducing more of our vaccines and more of our nutritional specialty products into the same area. And our customers have to get used to, again, different time of year, using these products. So we want to be -- we're cautiously optimistic as we go forward. We're very optimistic to the fact that we have managed and our customer managed to move very, very quickly away from some -- using some antibiotics that worked extremely well to using these new nutritional products that work well. But it's an ongoing cycle. So it's hard to predict what's going to happen 2 months from now, 3 months from now, 6 months from now. We're seeing a continuing uptake in the use of our vaccines, a continuing uptake in the use of our nutritional specialties as people are starting to replace some of these antibiotics. And this is unfolding.

Erin Elizabeth Wilson - Crédit Suisse AG, Research Division - Director and Senior Equity Research Analyst

Okay, great. And outside of sort of the medically important MFAs but within that MFA category, where are you seeing -- and I think you mentioned it earlier in the prepared remarks, where are you seeing some of the offsets outside of vaccines and nutritional specialties?

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

So -- and so there is a range of products in our MFA category that are not antibiotics. And some of these are older products. Some of these are chemical products. And as customers move away from using antibiotics, they necessarily are going to move to products that are not antibiotics but are -- but perform quite well. So within our portfolio, as Dick was mentioning, we had some of those products. Those products have increased sales while the antibiotics have dropped. But -- and again, we -- holistically, we're treating an animal, and we're going to treat the animal with a range of products. And it's vaccines, and it is nutritional specialties, anticoccidials, antibiotics. And again, we want our customers to raise their animals as healthy -- healthy and to create profitability.



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

Yes. And the only thing I'd add to that, Erin, is our -- within that MFA category, the demand for our broad product range in many international markets continues unchanged. So the MIA concept is largely a U.S. concept.

Erin Elizabeth Wilson - *Crédit Suisse AG, Research Division - Director and Senior Equity Research Analyst*

Okay, that's helpful. And can you speak to some of the increased product development efforts that you were mentioning? What categories will these focus on? And in what areas, I guess, do you see more of a meaningful opportunity either by a therapeutic class or a species?

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

So to there, we are increasingly spending our money on the parts of our business that are growing rapidly. So we're increasing spending in the vaccine segment. We're increasing our spending on development in nutritional specialties. That's on the development side. These products are used across many species, I mean, easily -- per species and heavily our businesses in the poultry area, where we increasingly look to move these products into the swine market and potentially even to the cattle market.

Operator

(Operator Instructions) And at this time, I'm showing no further questions. I'd like to turn the call back over to Mr. Richard Johnson for closing remarks.

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

Well, we'll just say thank you to everyone, and we'll talk to you in late August when we announce our annual fiscal year results and talk about guidance for next year. So until then, take care. Bye, everybody.

Operator

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

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