

May 10, 2016

Phibro Animal Health Corporation (PAHC)

Q3 March 31, 2016 Earnings Call



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CORPORATE PARTICIPANTS

Richard Johnson *Phibro Animal Health Corporation - CFO*

Jack Bendheim *Phibro Animal Health Corporation - CEO*

CONFERENCE CALL PARTICIPANTS

Brandon Folkes *Guggenheim Securities LLC - Analyst*

Erin Wilson *Credit Suisse - Analyst*

Anantha Narayan *Morgan Stanley - Analyst*

Matthew Brooks *Macquarie Capital Markets - Analyst*

PRESENTATION

Operator

Good day ladies and gentlemen and welcome to the Phibro third quarter financial results conference call.

(Operator Instructions)

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

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Thank you operator and good morning everybody. Welcome to our earnings call for our fiscal third quarter which ended March 31, 2016. As usual on the call today are Jack Bendheim, Chief Executive Officer and myself, Richard Johnson, the Chief Financial Officer. We will provide an overview of results, walk through the updated guidance we've provided and then we'll open the line for your questions. It will just be standard 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 are also providing a simultaneous webcast for this morning's call, which can be accessed on the website as well. Today's presentation slides and 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 to you 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 accepting accounting principles, or US GAAP. I refer you for 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.

And with that I will turn it over to Jack for some introductory comments.

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

Thank you Dick, and thank you all for joining us on this call. Our adjusted EBITDA, which was up 16% over last year, was on plan for our third quarter, but we were disappointed with our sales performance.



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Our core Animal Health segment showed a 3% sales increase which is lower than we had been experiencing and expecting. As mentioned in our press release last night, some of our US customers are reducing usage of antibacterials that are classified as medically important by the FDA, in anticipation of upcoming regulatory changes and in response to consumer preferences for the reduction or elimination of antibacterials in protein production.

Still, while our US MFAs and others declined in the quarter, our overall volumes in this segment grew, led by our international volumes. This volume growth, however, was tempered by pricing pressures from the strong US dollar. We believe international volume increases will continue to be a substantial offset to potential US decline. Nutritional Specialties grew even in the face of a difficult dairy environment, and our vaccine segment reported growth as producers seemed to look for alternatives to maintain the health of their animals.

We closed on our acquisition of MVP Laboratories in late January, and I have been very pleased with the smooth transition that has taken place, and am impressed with the caliber of our new colleagues.

Finally, we were disappointed in the FDA's actions regarding our Mecadox product that occurred in early April. Dick will provide a bit more color with regard to the next steps in the process initiated by the FDA, but I want to reiterate our strong belief in Mecadox' s safety, and our commitment to work with the FDA in seeking to address any concerns they may have.

I will now turn this back to Dick and look forward to answer any questions you may have following his more detailed review of the quarter's financials.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Just looking at page 4 for a moment of our webcast, Jack talked to most of those factors, just to highlight the point that we brought out in the press release, we are giving additional granularity that our current annual US sales of medically important antibacterials that are used in Animal Health are approximately \$40 million. And as we said, some of these sales could be at risk going forward due to the -- both the regulatory factors and the consumer preferences as we move forward.

On the other hand, we do believe the international growth in the same product groups are a substantial offset or, a growth opportunity as we are not seeing those same sorts of pressures internationally.

Turning to page 5 on the carbadox, or Mecadox issue with the FDA, as we said, safety, first of all, is our highest priority and we do intend to continue to collaborate fully with the FDA. The next step is for us to deliver all of our scientific information, data analyses, and information et cetera, by an early July deadline. We will deliver all of that information to the FDA with the intention that, that will be the basis to address the FDA's concerns.

At that point forward, then the timeline for further action by the FDA is undefined, so we can't speculate or speak to how the process may play out from that point forward. Important to note is we continue to market the product and as we've disclosed previously, our annual US sales of carbadox are in the \$15 million range.

Turning to our consolidated results for the March quarter, we reported \$183 million of sales, and that was down \$2 million or 1% from last year. By the way, in all of our comparisons we are doing here, we set aside the final milestone payment of \$2 million which was both in revenue and falls all the way to the bottom line in EBITDA. We've set that aside from the comparison so it is more of an apples to apples comparison.

Driving sales for the quarter was volume growth in Animal Health, particularly in the nutritional specialties and vaccine categories. Also we had volume growth in Mineral Nutrition, but we saw revenues pulled down by the pass-through of lower commodity prices.

At the gross profit line, on an adjusted basis, we had an adjustment to cost of goods sold, a typical thing for the acquisition of MVP, and you have to step up the cost of the inventory you acquire. So adjusting that out, gross profit was up 8% quarter over quarter, and driven by the same things we've been speaking to for some time now: volumes and mix, improved operating efficiencies in manufacturing, getting the benefit of some of the Capex we've been investing in manufacturing, and also favorable benefit from currencies as some of our products are manufactured outside the US where the strong dollar has helped our cost of goods.

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At the SG&A line on a consolidated basis, again on an adjusted basis, SG&A was up modestly, it was up 2% year over year, or about \$0.5 million. That was all of the increase essentially was in the Animal Health segment as we continued to invest selectively in sales, marketing and development.

That brings us to adjusted EBITDA, which was up 16% year over year, improved our operating margin to better than 16%, 250 basis point jump over last year. When we go to adjusted diluted EPS, up only 6%, the EBITDA increase drove that, but in part a slight increase in interest expense due to the cost of the borrowing for the financing of the MVP acquisition, but more substantially a higher effective income tax rate in the quarter as we saw a shift in the mix of our pretax income from domestic to international, and we saw our taxes increase as a result. And you've seen that, just anticipate going forward, you have seen that in the guidance for the full year also.

Moving to Animal Health, sales overall up 3% driven by continued double-digit growth in nutritional specialties, \$3 million of sales or 15% growth. And vaccines, again setting aside that milestone item from last year, vaccines grew almost \$1 million or 8%. The vaccine growth was driven by the MVP acquisition, but we did have an offset with some reduced sales in international due to some production upgrades we did for GMP, good manufacturing practices reasons. Those upgrades have been completed and that was a fairly momentary issue as far as affecting sales levels.

In the MFA side, US volumes were down year on year; however, we saw good growth in international that offset most of the US volume decline. Similar, the March quarter was similar to what we talked about in our December quarter. Dropping down to EBITDA, EBITDA was over \$32 million, better than 27% of sales. A \$4.5 million increase over last year, and continue to see that operating margin improve nicely over time.

Turning to other segments, Mineral Nutrition, revenue dollars top line were off as we talked about, it's basically commodity pricing and this is a pass-through type of business. We saw good volume growth in the business, and you see that on the bottom line as EBITDA did grow to \$4 million, about a \$300,000 increase over last year, or 7% growth at EBITDA despite the revenue shortfall.

Performance Products, not a lot to say, a fairly steady performance on a run rate basis. \$12 million of sales and \$0.5 million of EBITDA. And corporate expenses basically unchanged from last year at about \$7 million.

Just looking at our balance sheet and cash flow for a moment, our leverage ratio was, on a reported basis was up 3.3 times at March 31, and this reflects the \$46 million plus that we invested in the MVP acquisition, and that we funded by increasing our revolver. So, at the end of March \$367 million total debt, \$113 million of trailing adjusted EBITDA, gives you that 3.3. \$32 million of cash on hand and, during the quarter we used -- net cash flow before financing, we used \$53 million of cash, and obviously \$47 million of that was for the MVP acquisition.

Working capital used about \$15 million as the timing of payables and other liabilities used cash. In addition, we saw some increase in inventories also using cash in the quarter, and then finally we spent about \$11 million of Capex in the quarter.

Trending, I think we now have \$28 million or \$29 million of Capex for the nine months, still tracking toward our guidance of \$35 million plus or minus Capex for the year. And finally dividends, routine, we paid a \$0.10 a share dividend in March and declared and will pay the next one in June. No change there.

Turning to updated guidance, we have tightened our guidance for the year. We are now nine months into our fiscal year, we brought our revenue guidance down to \$745 million to \$750 million, that's just slightly above last year.

Adjusted EBITDA now is expected to be between \$114 million and \$115 million, still a nice increase over last year, a 12% to 13% increase over last year and 150 basis point improvement in the operating margin. And adjusted EPS now \$1.58 to \$1.60, a 4% to 5% increase over the prior year, as that higher effective tax rate due to our mix of international taxes is one of the -- is the primary factor, as well as slightly lower EBITDA guidance also a factor pulling down adjusted EBITDA guidance for the year.

The other guidance point here is that we expect our Animal Health segment revenues to be between \$477 million and \$482 million for the year, so 3% to 4% growth. And within that I think you will see that we would expect full-year growth to be quite the same as what we've seen through the first nine months.

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Some other guidance on interest expense and income taxes, I commented about earlier. So, that is the end of an overview of our numbers and our guidance so with that operator let's open it up for questions please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Brandon Folkes, Guggenheim Securities.

Brandon Folkes - Guggenheim Securities LLC - Analyst

Thanks for the additional color. Could you please just talk about the headwinds you're seeing within the MFA segment? Are these limited to medically important antibiotics, or are you seeing producers curtail some use of non-medically important antibiotics? Secondly, perhaps, if you can talk a bit more in detail, it looks like there are a lot of segments that [are] doing well, so if you could talk about the international markets where you've seen the growth, and then in nutritional specialties and vaccines, if you could just give us some color, are you taking market share, or are these new products? And then finally, how important are Performance Products and Mineral Nutrition businesses to you strategically? Thank you.

Jack Bendheim - Phibro Animal Health Corporation - CEO

It's Jack, I will take most of those. Let me start by saying that the overall premise of the business, which is tied to population and wealth growth around the world, and the increased demand for protein is absolutely continuing and is the same. Having said that, there are bumps, right? There are bumps in Brazil, bumps going on in China, there is stronger and weaker economies around the world. Fundamentally, we are continuing to see more production and more consumption of poultry, pig, cattle, and dairy products around the world. And that's the market we serve. And we serve those markets with a range of products. So we will continue to see demand for our antibiotics, anticoccidials, vaccines and nutritional specialties around the world. And that is the fundamental business.

Overlaid on top of that is some consumer-driven demand in the United States which is reacting to an unusual time. Because you have this FDA guidance, that we've been working on for the last four or five years, which created a new category. It's a category limited to the United States called medically-important antibiotics, MIA, MIAs. And the producers are trying to react to a regulatory change that's going to happen on January 1, 2017. Overlaid on top of that are, call it, demands from a certain segment of the population, let's call it -- I won't give it a name, but a certain segment of the population who think the best way to have chickens is to grow it -- or eggs -- is to grow it in your backyard in Brooklyn. And there is just a general demand of people wanting, or thinking they want more healthy foods, and they think that's use less antibiotics.

The reason producers use antibiotics is because they are treating bad bacteria, bacteria which is causing the animal to be sick, animals not to grow well, animals to die. The bacteria remains the same. The bacteria is out there. So what does a producer do when the consumer says, I want to buy a product that has not been raised with antibiotics, and yet the animals get sick? So the producers of the United States are, in a way, flailing around. They are looking for what they can use. And this is a very unusual time. Some of the responses will be to try more vaccines, some the responses -- which we believe we're going to see, and we have seen growth, is nutritional specialties.

And, ultimately everyone will be able to use a range of antibiotics. No one is saying -- none of these antibiotics that we produce, or our competitors produce, are being banned. They are all allowed to be used, and it is going to be pushed by, one, consumer preferences, but under that is concern about the welfare of the animal. You don't want to see an animal in pain, suffering because they were not -- you withheld drugs from them.

So this is a confusing time, I think it will be sort of worked out pretty much as we get into 2017, but 2016 we may, you know, call it a moving target. And there are lots of targets moving around. We think we have the answers to most of these problems. It is changing, so we expect, again, growth



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on the overall business because the overall demand for protein continues to grow. Within that we are going to see changes in the various markets we're in. I don't know if I answered most of your questions, but hopefully I did.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Just a couple of things on the growth drivers you were asking about Brandon, I think internationally we are seeing growth in most of the markets we are in. We tend to be in developing markets where the demand for protein production continues to grow, and also we are in a number of the big export producers, for example Brazil, where that continues. Each market has its own set of circumstances and maybe doing better or doing worse, but the underlying fundamentals remain the same. Nutritional specialties, I think we are largely -- some of our products are an alternative to some of the products currently used, and on the vaccines I think we are taking -- we have a good set of products that are competitive out there.

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

I would add on top of all of this that we continue to drive the business to make money. So yes, sales have been disappointing, a lot is driven by the commodity prices drop, and the fact we have sales drop in the Mineral Nutrition business. But, at the end of the day, our earnings are up 16% quarter to quarter, and that is ultimately what we all get paid for and how we look to drive the business.

Now I remember your last question. Mineral Nutrition remains a fundamental part of our business. It's how we see the customers, how we have face with the customers, and that has enabled us to be as successful as we are and continue to be in nutritional specialties. Performance Products, we said before, is not a core business. Business is smaller than it has been and I think that will be the case over time.

Brandon Folkes - *Guggenheim Securities LLC - Analyst*

Thanks very much.

Operator

Erin Wilson, Credit Suisse.

Erin Wilson - *Credit Suisse - Analyst*

Great, thanks. Just to kind of follow up of on the MFAs, and thanks for the clarity on the \$40 million, but can you speak to those specific offsets of products where you are seeing the pressure, and is that \$40 million, that's a global number, does it -- it includes the treatment and prevention purposes or indications as well? I assume it includes that \$10 million to \$15 million that you called out before, where you've seen pressure.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

The \$40 million is the US number. It's our US sales of medically-important antibacterials, and we tell you what the three molecules are. The \$40 million is the total number, the \$10 million to \$15 million in the risk factor is a subset of the \$40 million. And I guess the other part was, are there any product offsets?

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

It's Jack, Erin. We are growing, and we've seen the growth in our nutritional specialties. There will be some of these offsets. But I said earlier, the customers are sort of wrestling with the problem because again, the bacteria is there, they have to raise now to meet the demand of the marketplace and they're not exactly trying lots of different things. We think we have really good solutions for some of these problems that they are going to

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see, and we have a lot of customers testing, we have a lot of customers buying, but it is a big market and it is going to take a while for this all to sort through.

Having said all that, we don't look at our MFAs in the US -- MIA MFAs -- going to zero. We put it out there as a number, but ultimately drugs treat sick animals. I'm trying to think, it's like sometimes -- Airborne, when I go on a plane with my wife she always, often takes Airborne because she thinks this Echinacea and the other stuff is really going to help her prevent diseases. And for some people it works, but when you get sick you want to use an antibiotic, or you want to use a vaccine. And I think the same thing for the animals.

We are going to try to do lots of things to make the animals stronger and healthier and try to push off the diseases but ultimately when the animal gets sick, and often these animals get sick because they are subject to weather changes and other kinds of pressures like humans are, you are going to need to treat the animal and we have products that have been on the market for 35, 40 years that are very, very safe, very, very effective, and very cost-effective. So that is the base of the business. All, as I said earlier, this all will start out in the course of the next 6 to 12 months, right now we're smack in the middle of it.

Erin Wilson - Credit Suisse - Analyst

Are you also influenced by, more recently, some of the other animal health industry constituents have noted a rotation in the some of the use of medicinal feed additives, and I know that always happens in that -- in particularly the poultry business. Are you seeing a major shift in your customer base, given that natural rotation that always happens in the business? Is there some sort of unique phenomenon going on?

Jack Bendheim - Phibro Animal Health Corporation - CEO

There's nothing unique going on. We always see rotations. We read your piece as well. We see rotations going on that could account for some dips in one quarter, but then you pick it up the next quarter or six months later. That always happens. You're never sure at the time -- it's never the same every year, but ultimately as we've discussed often, the producers, let's say the chicken producers, the pig producers, only have certain products available to them to treat diseases. No one is adding new products into this field. These are the products that have been around for a very, very long time. They are effective, they are safe, and they are relatively inexpensive. And that is what the whole thing is about.

You cannot give up products. There are only three or four products, and everyone gets its share in the docket because the other products don't work as well. That comes back to the rotation story. We might be seeing in this quarter a bit on rotation, we might be seeing a bit as people are trying different ways to raise animals. Everything is a mix, everything is going on. And the overlay here as well, is that our customers have the benefit of today, relatively cheap input costs. Soybean and corn prices are low, that changes we know as well. Then everything moves at the same time.

So it is a big mix. I think our guys have done, as I said earlier, a great job in pushing our products where we are making money, and not just banging out sales but looking to continue doing that. And this business is in the midst of a big shift but as I said earlier, the shift will be a combination of not just MFAs, but it will be a combination of MFAs, it will be a combination of different vaccines, as well as these nutritional specialties, which is growing. It is a business that did not exist five years ago, but it is a business that will exist now and will continue to exist and will grow, and I think we are at the forefront here in the ability to find the right product and to market the right product.

Erin Wilson - Credit Suisse - Analyst

Just one quick one, can you quantify how much MVP contributed in the quarter, and what does the deal pipeline look like near-term?



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Jack Bendheim - *Phibro Animal Health Corporation - CEO*

Erin, you are always so good about this, no we're not. What I can say is that our original view of the business has been exceeded. We are very, very satisfied with MVP, with its people and its product line, and that will continue to grow with us as we go forward.

Operator

David Risinger, Morgan Stanley.

Anantha Narayan - *Morgan Stanley - Analyst*

Hi, good morning. This is Anantha, on the call for Dave. Thank you for taking our questions I have two questions please. First, regarding the MFA business, could you please comment on the cadence of the headwinds as we move towards December 2016? Do you expect it to be more loaded in the back half of the calendar year? And second, could you please discuss the Mineral business outlook and how investors should consider modeling that? Thank you.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

If I were going to restate your question, you're saying, will we see -- is this the sort of activity we're going to see as we move along through calendar 2016, or are we going to see more pronounced erosion in our sales? We've given you guidance through June. I think that June guidance pretty much tells you that we see similar -- a similar trend through June, and I think we are, as Jack said, this is a point where many of our customers are in transition and they are trying a lot of different things. So, really not going to speculate beyond that. And the second part of your question, if you could say that again?

Anantha Narayan - *Morgan Stanley - Analyst*

Can you discuss the Mineral business outlook, and how we should think about modeling that going forward? Thank you.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

The minerals, it is difficult to model the top line, there is no sense trying to model what commodity prices are going to do. The bottom line is, we expect that business to be a solid, steady, growing contributor. We have said before that it is tied to animal numbers in the US, and so it is a low single-digit type of growth business and we would expect our EBITDA to continue to grow in that kind of a range, with maybe a little bit of upside as we get efficiencies and some leverage on some of our expenses. That is how you think about that, from a modeling point of view.

Anantha Narayan - *Morgan Stanley - Analyst*

Thank you.

Operator

Matthew Brooks, Macquarie.



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Matthew Brooks - *Macquarie Capital Markets - Analyst*

Just a few follow-up questions on the MFAs. Firstly, can you say how much of your MFA sales are in the USA specifically, and how much of that goes to the poultry segment?

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

Yes, you can -- I don't even have the number off the top of my head, but I think we say our animal health segment is about 45% in the US, yes it's 45% across the entire segment. And the US is -- MFAs is probably similar to a slightly less percentage. I'm stumbling around. What was the second part of your question?

Matthew Brooks - *Macquarie Capital Markets - Analyst*

What share of that go to the poultry segment? Are most of the MFAs going to the poultry segment?

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

Poultry and swine, but predominantly to poultry.

Matthew Brooks - *Macquarie Capital Markets - Analyst*

In the USA, you said that you are seeing some lower demand for MFAs. Is it only the medically-important MFAs that are affected? If you look at it from the consumer's point of view, you know, they go into a restaurant, they are not saying, I want antibiotic-free but I don't want only the medically-important MFAs. They say, I want antibiotic-free

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

There is a whole range of products that go into chickens which might not be defined as antibiotics, but are fed through, put in the animal through feed. These products are not affected by people saying -- their requests for antibiotics. Antibiotics is a defined term. And most of the industry, if you read through most of the producers, I would say the trend is to try to focus on what is medically important, and yet to use a range of other products, including some antibiotics, in order to treat coccidial diseases and all of the diseases that these animals have, and there is no other way to do that. Ultimately, the consumer, when they order chicken, want chicken delivered and not some other something else because chicken is not available.

Matthew Brooks - *Macquarie Capital Markets - Analyst*

As a follow-up to that, you've seen some substitution towards nutritional specialties, and you've got your own Magni-Phi product? Are you doing any R&D to try and find other ways, to find substitute products, for those medically important MFAs?

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

That is how we got to the Magni-Phi product line, and we continue to look. This is not a simple task at all, we are dealing with lots of conditions, cocci, bacteria, viruses, a whole range of things that go on in an animal that need to be dealt with. And remembering that the chicken lives for 4 to 5 weeks, and they don't have a long time to treat the animal before it gets slaughtered, so we're not going to see a huge, huge shift away from what is necessary to raise animals. And again, you know I saw an article the other day, there is some segment of the market can say, we will spend \$20 for a chicken. That might be true, but that's not most of us.



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Overall it's a tumult right now, we are right in the mix of everything. Lots of stuff going on, but we should not forget at the end of the day that the US produces the healthiest, most wholesome and least expensive protein of pretty much any country in the world. That's what people expect, that's what people demand. And while we can adjust some of that, and we should adjust some of that, the market is willing to pay for it. Overall there are lots and lots of people out there that do not want to see their choices limited because they can't afford it.

Matthew Brooks - *Macquarie Capital Markets - Analyst*

On a separate topic, looking at the inventories, it seems like there is a pretty big bump compared to last year. It looks high relative to sales. Is that partly due to the MVP acquisition, or is the jump in inventories related to slightly weaker sales?

Richard Johnson - *Phibro Animal Health Corporation - CFO*

It is primarily the latter. We did build some inventories in anticipation of higher sales and now we will pull those back down. We recognized that some time ago, but a lot of these supply chains are pretty long between initial sourcing or production and finished good products, so we are adjusting that as we go. MVP was a small part of the dollar increase.

Matthew Brooks - *Macquarie Capital Markets - Analyst*

And on a potentially more positive question, the US dollar has weakened a bit this year, while sort of down, well -- up year on year. Are you seeing any benefits from the weaker currency, particularly in Brazil?

Richard Johnson - *Phibro Animal Health Corporation - CFO*

What we've talked about is pricing pressure in some international markets, and Brazil is an important market for us, and so with the Brazil currency strengthening back a bit from where it had been, that takes a little bit of the pricing pressure off and makes it a little easier for us, for our customer to make the sale and take some volumes.

Matthew Brooks - *Macquarie Capital Markets - Analyst*

Thanks Jack, thanks Richard.

Operator

(Operator Instructions)

I'm showing no further questions.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Okay everyone, we will come back to you and we'll be talking about our full-year results when we release them, probably in -- we haven't announced it yet, but it will either be late August or early September we'll be putting out our fiscal year results so, talk then. Goodbye everybody.

Operator

Thank you for participating in today's conference, this does conclude the program. Everyone have a great day.



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