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Phibro Animal Health Corp. (PAHC)

Q3 2022 Earnings Call

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May 5, 2022

CONFERENCE CALL PARTICIPANTS

>>Damian Finio - CFO

>>Jack Bendheim - CEO

>>Michael Ryskin - BofA Securities, Research Division

TRANSCRIPT

PRESENTATION

Operator

Good morning. My name is Shantal, and I'll be your conference thistime, I would like to welcome everyone to the Phibro Animal Health Corporation Third Quarter 2022 Conference Call. As a reminder, today's conference call is being recorded. (Operator Instructions) Damian Finio, Chief Financial Officer, you may begin your conference.

>>Damian Finio - CFO

Thank you, Shantel. Good morning, and welcome to the Phibro Animal Health Corporation Earnings Call for our fiscal third quarter ended March 31, 2022. My name is Damian Finio, and I am the Chief Financial Officer of Phibro Animal Health Corporation. I'm joined on today's call by Jack Bendheim, Fiber's Chairman, President and Chief Executive Officer; and Daniel Bendheim, Director and Executive Vice President of Corporate Strategy.

Today, we will cover financial performance for our third quarter as well as revised financial guidance for our fiscal year ending June 30, 2022. At the conclusion of our opening remarks, we will open the lines for questions. I'd like to remind you that we are providing a simultaneous webcast of this call on our website, pahc.com. Also on the Investors section of our website, you will find copies of the earnings press release and third quarter Form 10-Q filed with the SEC yesterday as well as the transcript and slides discussed and presented on this call.

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 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 in our earnings press release for a discussion of these measures. Reconciliations 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.

We present our results on a GAAP basis and on an adjusted basis. Our adjusted results exclude acquisition-related items, unusual, nonoperational or nonrecurring items, including stock-based compensation and restructuring costs, Other income and expense are separately reported in the consolidated statement of operations, including foreign currency gains and losses net; and lastly, income tax effects related to pretax adjustments and unusual or nonrecurring income tax items.

Now let me introduce our Chairman, President and Chief Executive Officer, Jack Bendheim , to share his opening remarks, which will include his perspective on Phibro's third quarter financial performance and revised financial guidance for our fiscal year 2022. Jack?

>>Jack Bendheim - CEO

Thank you, Damian, and good morning, everyone. Our fiscal year-to-date sales reflect year-over-year growth of 12%, driven by double-digit sales growth across all segments. Consolidated sales growth was driven by a 10% improvement in our core Animal Health segment. We also posted sales growth of 16% and 12% in our Mineral Nutrition and Performance Products segments, respectively. Sales in these 2 segments correlated with the underlying cost of materials such as copper and we're seeing the benefits of higher prices than our top line.

Third quarter sales grew 13% over the same quarter 1 year ago driven by growth across all segments as well. During the quarter, we also acquired a business that provides product and services chiefly to the sugar-based ethanol industry in Brazil. We see this acquisition a chance to replicate the success we have had in the U.S. industry providing products and services for both the productive ethanol and its coproduct, many of which are consumed by lifestyle.

Pro forma information giving effect to the acquisition has not been provided because the results are not material to the consolidated financial statements, but the acquisition we ported Sparta Animal Health MFA and other product categories.

While our business is strong, macroeconomic headwinds persist, the Russian conflict with Ukraine and lingering impact with COVID-19 in some markets where we compete, specifically Asia Pacific are driving higher-than-anticipated inflation it could result in broader economic impacts and security concerns, which could adversely affect our business.

Since the conflict began, our company employees have provided support to Ukraine in form of monetary donations, pre-product and humanitarian services. We sell products indirectly to a European distributor in Russia. These sales represent less than 1% of our annual consolidated net sales.

Like most of our industry, our limited intent for the Russian market is to continue providing medicines and vaccines and on the ground related regulatory and technical support to help existing customers combat disease challenges in the production of food animals on their farm. We have no production or direct distribution operations and no planned investments in Russia. On a year-to-date basis, net sales in our Europe, Middle East and African regions represented 13% of consolidated net sales.

Obviously, COVID is still a wildcard in certain regions such as Asia Pacific. On a year-to-date basis, net sales in our Asia Pacific 2 region represents 7% of consolidated net sales.

Our top line growth includes the fact that we have taken price increases to combat historic levels of inflation. These price increases and freight surcharges partially dampened the impact of cost increases. But our third quarter bottom line also fell short of our projections due to co-related challenges with a key supplier that led to delayed sales and costlier shipments as well as the lost portion of our indirect sales to Russia due to the conflict.

The combined impact of these factors explains why we do not see the benefits of better pricing dropping to the bottom line. The supply issue is getting behind us, while the Russian \challenge continues. So to drive profitable growth, we will continue to take aggressive actions to raise prices when normal competitive conditions allow.

For these reasons, we are expecting improvement in our fiscal fourth quarter. We raised sales guidance and retained premiums communicated adjusted EBITDA guidance for the full year. Given year-to-date performance, revise full year sales guidance of $930 million to $950 million, which is a projected year-over-year increase of 12% to 14%. However, given the aforementioned challenges, uncertainty persists and therefore, we are maintaining our full year adjusted EBITDA guidance of $110 million to $114 million.

Overall, our industry is dealing with a challenging economic environment, but I'm very proud of what our teams here at Phibro have accomplished to help us maintain our competitiveness. With that, let me hand the call over to Damian to review our financial performance in more detail. before opening the lines for your questions. Damian?

>>Damian Finio - CFO
Thank you, Jack. I will start with consolidated financial performance on Slide 4, then cover segment level performance, key balance sheet metrics, and conclude with a review of our revised financial guidance for the full year 2022.

Consolidated net sales for the quarter ended March 31, 2022, were $239.6 million, reflecting a $27.9 million or 13% increase over the same quarter a year ago. This increase was driven by improvements across all reportable business segments, major product categories and geographic regions.

GAAP-based net income and diluted earnings per share increased 45% and 47%, respectively, versus the same quarter a year ago. The net income increase and resulting diluted earnings per share increase were driven by stronger volumes and selling prices driving higher gross profit. A $10.0 million increase in foreign currency gains, offset by a $3.5 million increase in income tax expense and higher SG&A expenses.

Although we reported a foreign currency gain again this quarter, volatility in foreign currency exchange rates continues. For Phibro, the impact was primarily driven by the effect of translating intercompany balances to the U.S. dollar for reporting purposes at the end of the reporting period. After making our standard adjustments to GAAP results, including acquisition-related items, foreign currency movements and one-offs, third quarter adjusted EBITDA was comparable to the prior year's quarter.

Included in the calculation of adjusted EBITDA is higher gross profit in our Mineral Nutrition business segment, offset by lower gross profits in our Animal Health segment and a slight increase in corporate expenses. Adjusted net income and adjusted diluted earnings per share declined 4% and 3%, respectively, due to the increases in employee-related and technology-related costs partially offset by higher gross profit driven by an increase in volumes and average selling prices.

Moving to segment level financial performance on Slide 5. I'll start with third quarter financial performance for our largest segment, Animal Health, which includes 3 product lines, namely MFAs another, nutritional specialties and vaccines. The Animal Health segment posted $148.6 million of net sales for the quarter, which represents an increase of $14.2 million or 11% versus the same quarter of prior year.

Within the Animal Health segment, we reported a $5.8 million or 7% increase in MFAs and other versus the same quarter of prior year driven by increased sales of processing aids used to improve production efficiency in the ethanol fermentation industry.

And, $4.4 million or 12% growth in Nutritional Specialties, driven by higher demand in dairy and microbial products as well as increased revenues of our companion animal products, Rejensa ®. And lastly, a very strong $4 million or 21% improvement in vaccine net sales driven by increased domestic and international volumes.

In terms of profitability for the segment, Animal Health adjusted EBITDA was $29. 2 million, a 6% decline from the same quarter prior year in dollar terms and a 330 basis point decline in adjusted EBITDA margin due to the challenges Jack highlighted in his opening remarks and an increase in SG&A expenses.

Moving on to third quarter financial performance for our other business segments on Slide 6.

Starting with Mineral Nutrition, net sales for the third
quarter were $69.0 million, an increase of $10. 9 million or 19% versus the same quarter prior year driven by higher average selling prices of trace minerals, correlated with the movement of the underlying raw material costs. Mineral Nutrition adjusted EBITDA was $7.3 million, reflecting year-on-year growth of $2.1 million or 40% and reflects an improvement in adjusted EBITDA margin of 160 basis points driven by increased gross profit derived from the higher average on prices.

Looking at our Performance Products segment. Net sales of $22.0 million for the 3-months ended March 31, 2022, reflects a $2.8 million or 15% improvement over the same quarter prior year. As a result of higher volumes of ingredients for personal care products and higher volumes and average selling prices of copper-based products. Adjusted EBITDA was $2.9 million comparable to the prior period with a modest decline of 2% and a 230 basis point decline in terms of adjusted EBITDA margin.

Lastly, corporate adjusted EBITDA declined 3% or set differently in corporate expenses increased 3%, driven primarily by increased technology-related costs and the planned and intentional incremental increase in strategic investments.

Turning to key capitalization-related metrics on Slide 7.

Free cash flow for the 12-month period ending March 31, 2022, was $1 million and was
comprised of operating cash flow of $33 million less $32 million of capital expenditures. Our gross leverage ratio calculated by dividing total debt of $417 million by trailing 12-month adjusted EBITDA of $107 million was 3.9x at the end of the third quarter. This is a slight increase from last quarter end and driven by an increase in total debt used to fund the ethanol industry related acquisition in Brazil that we executed in the third quarter. Note pro forma information giving effect to the acquisition has not been provided because the results are not material to the consolidated financial statements.

And in terms of liquidity, we had $216 million available at quarter end. This includes cash and short-term investments of $93 million and $123 million of unused and available revolving credit. The $17 million decline in available revolving credit from last quarter end is again related to the aforementioned acquisition. And it's important to note that the accessibility of availing revolving credit is subject to leverage ratio limitations outlined in our loan agreement.

Lastly, consistent with the past several quarters, we paid a quarterly dividend of $0.12 per share or $4.9 million in aggregate.

Now that I've had a chance to share our perspective on third quarter actual financial performance, I'd like to shift gears and explain how we're thinking about our fourth quarter an outturn for our full fiscal year ending June 30, 2022.

So please turn to Slide 8.

On our February 10 earnings call, we communicated our expectation that adjusted EBITDA margins would improve in the second half of our fiscal year, that was not the case in Q3. What we were unaware of on that call is that just 2 weeks later, Russia would invade Ukraine and the supply chain and economies that we expected to continue on the road to recovery from the impacts of the pandemic were pushed right back into an environment of uncertainty.

Specific to Phibro's third quarter, net sales were stronger than anticipated, but COVID-related protocols limited available staff at one of our key suppliers. The issue is mostly resolved, but the disruption did lead to some delayed sales and costlier shipments for those sales orders that we were able to fulfill.

We're also limiting indirect sales to Russia to existing customers of animal health products only, which translated into some lost sales in the third quarter and going forward. The combined impact of these factors and a bit of unfavorable noise relating to the timing of shipments and product mix explains why we did not see the benefits of better pricing dropping to the bottom line as projected.

Given our year-to-date financial performance, coupled with historic levels of inflation and persistent macroeconomic headwinds, we raised financial guidance for net sales with no change to adjusted EBITDA guidance. Revised financial guidance assumes price increases subject to normal competitive conditions have been and will continue to go into effect while freight surcharges, where applicable, have been and will continue to be applied.

In summary, our revised fiscal year 2022 guidance is as follows: net sales of $930 million to $950 million, which is an increase from the $890 million to $920 million last communicated. Adjusted EBITDA of $110 million to $114 million, as stated previously, no change there. Adjusted net income of $52.8 million to $56.4 million, adjusted diluted EPS of $1.30 to $1. 39 per share and an adjusted effective tax rate of 26% to 27%. All of which are unchanged and therefore, consistent with what we last communicated.

These full year projections on our existing base business imply a fourth quarter projected adjusted EBITDA margin of about 12% to 14% and would be an improvement over third quarter and year-to-date actual adjusted EBITDA margins of 11.7% and 11.6%, respectively.

In summary, we're confident and encouraged by the demand for our products reflected in our third quarter and year-to-date top line growth and although our price increases have somewhat lagged the cost increases we're facing with materials and distribution, we are also confident in our ability to continue raising prices, where competitive conditions allow.

Before we open the line for questions, I wanted to highlight that we plan to publish our inaugural Environmental, Social and Governance or ESG report shortly. On that day, we will issue a press release, which will provide a link to the publication on our website. This report is the output of a collaborative effort involving our team members around the world, and we are excited to officially be starting our ESG journey and share our story with you. That concludes our opening remarks. Shantal. Could you please open the lines for questions?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Michael Ryskin with Bank of America.

>>Michael Ryskin - BofA Securities, Research Division

This is [Wolf Chan] off on for Mike. I saw that you noted that sales of Rejensa continued to grow in the quarter. Can you give us a bit more color on how things have trended and maybe a high-level outlook for the balance of the year?

>>Damian Finio - CFO

So sales for our companion animal product Rejensa have been very strong. As we had said, I think, on earlier calls, we expected sales in fiscal year '22 to double over fiscal year '21. Our guidance reflects that this will be the case. And we'll get into guidance for fiscal year '23 on our call later in the summer, but we would expect that trend to continue next year as well.

>>Unidentified Analyst

Great. And then kind of turning to a bit more macro topic. Can you talk to the effects that you're seeing throughout in the U. S. on your beef and dairy franchises? How should we think about the implications of more cattle and feed lots for the sales of MFAs in the coming year? And is there any sense from customers that this may have a longer-term impact on U.S. herd sizes? Or should we be thinking about this as kind of a temporary headwind?

>>Jack Bendheim - CEO

Thanks for the question. As we've stated in the past, our sales to the U.S. beef industry is sort of limited to the dairy industry. So we -- the effect of the drought in the U.S. is not directly affecting us. There might be some indirect effect for our sales to the beef industry in Brazil and in Mexico and

Argentina other markets where we participate in. But what you're reading is happening, I mean, the drought is affecting, it's moving more cattle to feed lots and the level of slowed way is much higher than it has been the past.

Operator

There are no further questions at this time. I'll turn the call back over to Damian Finio for closing remarks. Damian?

>>Damian Finio - CFO

Okay. Thank you, Shantal, and thank you, everyone, for listening in on today's call. We appreciate your time, attention, questions and interest in Phibro Animal Health Corporation. Have a great rest of your day, and let's all hope for a peaceful resolution of the conflict in Ukraine very soon.

Thank you.

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