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Phibro Animal Health Corp. (PAHC)

Q4 2022 Earnings Call

CORPORATE PARTICIPANTS

Damian Finio, *Chief Financial Officer*

Jack Bendheim, *Chairman, President and Chief Executive Officer*

Daniel (Dani) Bendheim, *Director and Executive Vice President, Corporate Strategy*

CONFERENCE CALL PARTICIPANTS

John Kim, *Bank of America*

Justin Wang, *Morgan Stanley*

PRESENTATION

Operator

Welcome, everyone, to the Phibro Animal Health Corporation Q4 2022 Conference Call.

Thank you. Damian Finio, Chief Financial Officer, you may begin.

Damian Finio

Thank you, Chris.

Good morning and welcome to the Phibro Animal Health Corporation earnings call for our fourth quarter and year ended June 30, 2022. My name is Damian Finio, and I am the Chief Financial Officer of Phibro. I'm joined on today's call by Jack Bendheim, Phibro's Chairman, President and Chief Executive Officer; and Dani Bendheim, Director and Executive Vice President of Corporate Strategy.

On today's call we will cover financial performance for the fourth quarter and our full fiscal year ending June 30, 2022, and provide financial guidance for our fiscal year ending June 30, 2023. 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, www.pahc.com. Also, on the Investors section of our website, you will find copies of the earnings press release and Annual Report on Form 10-Q filed with the SEC yesterday, as well as the transcript and slides 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 pre-tax 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 the fourth quarter, full year financial performance, and guidance for our Fiscal Year 2023.

Jack?

Jack Bendheim

Thank you, Damian, and hello, everyone.

I am pleased to share that our fourth quarter and full year performance reflected top and bottom-line growth on an adjusted basis versus the respective prior periods.

Net sales for the quarter were up 16% versus a year ago; our full year sales were up 13%. What's most impressive is that each of our three business segments posted double-digit year-over-year percentage growth, reflecting strong demand for our product portfolio. And Adjusted EBITDA for the quarter was up 17% while full year Adjusted EBITDA was up 3%. Despite our strong financial results, our industry faces macroeconomic and operational challenges.

The consequences of COVID-19 still linger, which has helped a few global macroeconomic headwinds leading to significant inflation. For our customers this translates into higher feed, energy, and fertilizer prices which in turn drives higher food prices for consumers. At Phibro this means higher raw material and labor costs, which puts pressure on our margins despite increasing prices. We continue to work through supply challenges and labor shortages. Overall, the Company managed well through another challenging year, and our strong performance reflects the efforts of our loyal employees.

In response to higher input costs, we raised prices, but Phibro continues to act in other ways as well. Internally, we are addressing the impact of high input costs head on by identifying production efficiencies requiring investments in capital improvements. We will continue to drive efficiencies within our business by working collaboratively across business segments and geographic regions, leveraging our economies of scale where possible. As we look ahead, we are anticipating further year-over-year top and bottom-line growth on an adjusted basis in Fiscal 2023 with net sales projected to be in the range of $960 million to $1 billion and Adjusted EBITDA projections in the range of $113 million to $118 million, reflecting 2% to 6% growth in both key financial metrics.

In the face of these challenges, it's important that we continue to keep our eye on the future. I'm excited that, in addition to our existing projects, our companion animal development pipeline now includes a gene therapy opportunity targeting MVD in canines. Back in June, we announced this opportunity to the market, highlighting a collaboration for the development and commercialization of our gene therapy with our partner, Rejuvenate Bio. They expect to file for a conditional approval as early as Calendar Year 2023. We're looking forward to progressing these projects and the prospects they add to our medium-term outlook.

Overall, it was another challenging year, but we posted a solid fourth quarter and a full fiscal year strong financial performance.

With that I will ask Damian to go through our actual results and projections in more detail before opening the line for questions.

Damian?

Damian Finio

Thank you, Jack.

Let me start with our consolidated financial performance for the fourth quarter ended June 30, 2022, versus the same quarter one year ago.

On a consolidated basis fourth quarter net sales increased $35 million, or 16%, driven by growth in all three of our business segments, namely Animal Health, Mineral Nutrition, and Performance Products. GAAP based net income and diluted EPS both declined 56% versus the same quarter a year ago. The decreases were driven primarily by increased foreign currency losses of $8.3 million and a $5.9 million increase in provision for income taxes, offset partially by $3.7 million more in operating income and $0.8 million less interest expense.

After making adjustments to our GAAP results, which include acquisition related adjustments, foreign currency movements and one-offs, fourth quarter Adjusted EBITDA, adjusted net income, and adjusted diluted EPS were up 17%, 13%, and 13%, respectively, driven by higher Animal Health revenue and gross profits as well as stronger Mineral Nutrition gross profit, partially offset by increased selling, general, and administrative expenses.

On Slide 6, looking at the same financial metrics, but now for the full year on a consolidated basis, our full year financial performance improved over the prior year. Net sales increased $109 million, or 13%, driven again by growth across all three business segments: Animal Health, Mineral Nutrition, and Performance Products. GAAP based net income and diluted EPS for the full year declined 10% versus the prior year, driven by increases in the provision for income taxes and selling and general administrative expenses, offset by improved operating profits less interest expense and foreign currency gains. After adjusting GAAP results for one-off acquisition related items and foreign currency movements, Adjusted EBITDA improved 3%, driven by sales and gross profit growth, offset by an increase in strategic initiatives, while adjusted net income and adjusted diluted EPS improved 4%, driven by higher gross profit on higher sales, offset partially by increases in SG&A costs driven by incremental strategic investments.

Turning to business segment performance on Slide 7, starting with the fourth quarter financial performance of our largest segment, Animal Health, which is comprised of the MFAs and other nutritional specialties and vaccine product categories. Net sales increased $20 million or 13% versus the same quarter prior year. The increase in our Animal Health segment net sales was driven by improvements in all product categories. First, a 12% increase in MFAs and others versus the prior quarter, driven by higher average selling prices, and increased sales of processing aids used in the ethanol fermentation industry. Second, a 15% improvement in nutritional specialties net sales driven by strong domestic demand in dairy, growth in the Asia Pacific region, and strong demand for our companion animal product, Rejensa. And third, a 19% improvement in vaccine net sales driven by strong demand across all regions. In terms of profitability, Animal Health Adjusted EBITDA was $33.5 million, an increase of $4 million or 14% over the prior year quarter, while Adjusted EBITDA margin was flat. The improvement was driven by the increase in revenues and resulting gross profit, offset partially by an increase in selling, general, and administrative expenses.

Moving to Slide 8, which reflects full year financial performance for our Animal Health segment. Net sales were up $61 million or 11% versus the prior year. The increase in Animal Health full year net sales was driven by a 10% increase in MFAs and other versus the prior year, primarily due to increased demand for MFAs, particularly in the Latin America and China region, coupled with strong demand for processing aids used in the ethanol fermentation industry. Also, 10% growth in nutritional specialties driven by strong international and domestic demand, particularly for dairy, coupled with growth in our companion animal product, Rejensa. And lastly, a 21% increase in vaccine net sales driven by strong demand in most regions. In terms of profitability, Animal Health Adjusted EBITDA for the year was $124 million, which was consistent with the prior year, while the Adjusted EBITDA margin declined 230 basis points as stronger sales and gross profits were offset by higher selling, general, and administrative expenses, reflecting the impact of higher-than-typical inflation and the macroeconomic headwinds (audio interference).

Moving on to fourth quarter financial performance for our other segments on Slide 9. Let's start with Mineral Nutrition, net sales for the fourth quarter was $69.4 million, an increase of 22% versus the same quarter in the prior year, driven by higher average pricing of trace minerals. Mineral Nutrition Adjusted EBITDA was $6.7 million, an increase of 44% driven by increased gross profit, and the Adjusted EBITDA margins for the quarter was 9.6%, an improvement of 150 basis points versus a year ago.

Moving to our Performance Products segment, we finished the year strong with net sales of $19.3 million for the three months ended June 30, 2022, reflecting an increase of 16% over the prior year same quarter, driven by strong demand and pricing for copper-based products as well as strong demand for ingredients used in personal care products. The increased demand drove Adjusted EBITDA of $2.4 million for the quarter, a 5% improvement versus the same quarter prior year, while the Adjusted EBITDA margin declined 100 basis points to 12.3%. Lastly, corporate expenses increased 17% from $1.6 million versus the same quarter prior year, primarily driven by an increase in investments relating to strategic initiatives.

Now looking at full year financial performance for these segments on Slide 10. Mineral Nutrition net sales for the full year were $260 million, an increase of 18% versus the prior year, driven by higher average selling prices of trace minerals. Mineral Nutrition Adjusted EBITDA was $24 million, an increase of 40% driven by increased gross profit on favorable product mix. And Adjusted EBITDA margin for the quarter was 9.3%, an improvement of 150 basis points versus one year ago.

Turning to full fiscal year results for our Performance Products segments. Net sales was $76 million, an increase of 13% over the prior year, driven by strong demand for ingredients used in personal care products and strong demand and favorable pricing of copper-based products. However, Adjusted EBITDA of $8.7 million represents a decline of 8%, and was driven by higher raw material and production costs versus the prior year. Consequently, Adjusted EBITDA margin declined 270 basis points to 11.5%. Lastly, corporate expenses increased $3 million or 7% versus the prior year. The increase was driven primarily by an increase in investments relating to strategic initiatives. I'll discuss our projections for Fiscal Year 2023 momentarily, but it's worth mentioning now that we intend to continue investing in the Company's future despite the pressure that the macroeconomic environment is putting on margins. So, corporate expenses will increase again this coming year.

Turning to key capitalization related metrics on Slide 11. On a trailing 12-month basis, free cash flow was a negative $5 million as capital expenditures exceeded operating cash flow generated by the business. As discussed on previous calls, we have been intentionally building inventory levels to both support our top line growth but also to better manage supply chain disruptions. However, because of the effects of inflation, it's more expensive to replace those inventories as they are depleted, thus consuming cash. To free up more cash, we are placing even more attention on monitoring inventory levels and leveraging our economies of scale to drive more competitive freight costs. Of course, given these inflationary times this will be a challenge, but our anticipation is that free cash flow will improve going forward.

Moving on, our gross leverage ratio was 3.9 times at June 30. This is calculated by dividing total debt of $434 million by a trailing 12-month Adjusted EBITDA of $111 million. I want to note that we use net debt and Adjusted EBITDA as defined by our existing loan agreement to calculate the net leverage ratio used for covenant compliance purposes. In terms of liquidity, we had $194 million available at year end. This includes cash and short-term investments of $91 million and $103 million of unused and available revolving credit. The accessibility of available revolving credit is subject to leverage ratio limitations outlined in the loan agreement. And lastly, consistent with the past several quarters, we announced a quarterly dividend of $0.12 per share or $4.9 million.

That concludes our perspective on both fourth quarter and full year financial performance, so let's turn our attention to the outlook for Fiscal Year 2023.

Please turn to the financial guidance shown on Slide 12. For Fiscal Year 2023, largely driven by strong demand for our products across all regions, coupled with the annualization of price increases taken in Fiscal Year 2022, we are projecting consolidated net sales in the range of $960 million to $1 billion, which reflects a year-over-year growth rate of approximately 2% to 6%. Underpinning these consolidated top line projections is the assumption that we can grow our largest segment, Animal Health, by 3% to 7%, which is driven by anticipated double-digit percentage growth of nutritional specialty products as we continue to drive the use of direct fed microbials and further increases in the sales of Rejensa, our companion animal product, as well as healthy growth of our other two Animal Health product categories, vaccines, MFAs and other.

For our other business segments, namely Mineral Nutrition and Performance Products, we are projecting flat to low single-digit percentage sales growth as the sales of these segments directly correlate to the underlying cost of raw materials and we have seen indications that customers are managing their inventory levels to help combat the incremental cost of inflation. Despite the pressure on margins, we are steadfast in our commitment to continue investing in the Company's future. We are planning $37 million of investments in strategic initiatives, an increase of $8 million over Fiscal Year 2022. This includes, but is not limited to, investments in our companion animal development pipeline, African swine fever, continued registration of products in new markets, and the ongoing build-out of our newest vaccine production facility in Sligo, Ireland. We also intend to spend $39 million on capital improvements, which is an increase of $2 million over Fiscal Year 2022. This includes, but is not limited to, a significant investment in our large production facility in Quincy, Illinois, which will increase manufacturing capacity, and in turn lower projected per unit costs, expanding vaccine manufacturing capacity at several locations and completing efficiency projects at our facilities in Israel.

As such, with the annualization of price increases and actions taken to manage costs, we are projecting Adjusted EBITDA in the range of $113 million to $118 million, which also reflects a growth rate of 2% to 6%. On a GAAP basis, net income and diluted earnings per share are projected to be flat or declining by up to 8%, largely dependent on movement in our tax provisions, including uncertain tax positions, often referred to as FIN 48 reserves, as well as movements in foreign currencies.

For adjusted net income and adjusted diluted earnings per share, we are projecting a decline of 2% at the low end of the range and an improvement of 5% at the high end. In terms of our adjusted effective tax rate, we are projecting a rate of about 30%, which is in line with our actual adjusted effective tax rate in Fiscal Year 2022 and 2021. Lastly, and consistent with last year's quarterly trend, we expect a seasonal-driven decline in our upcoming first quarter net sales and Adjusted EBITDA relative to the fourth quarter of Fiscal Year 2022 with quarter-on-quarter improvement as we progress through Fiscal Year 2023.

In summary, our Fiscal Year 2023 financial guidance is as follows. Net sales of approximately $960 million to $1 billion, reflecting growth of 2% to 6%. On a GAAP basis, net income of approximately $45 million to $49 million and diluted earnings per share of $1.11 to $1.21. Adjusted EBITDA of approximately $113 million to $118 million, reflecting growth of 2% to 6%. Adjusted net income of approximately $52 million to $56 million and adjusted diluted EPS of approximately $1.28 to $1.38, reflecting a year-over-

year 2% decline on the low end of the range or 5% growth on the high end, and an adjusted effective tax rate of 30%, which is comparable to the 29.5% actual effective tax rate for Fiscal Years 2022 and 2021.

Overall, we had a strong fourth quarter, posted net sales and Adjusted EBITDA performance improvements for both the quarter and the full year, and we are projecting further growth in Fiscal Year 2023.

That concludes our opening remarks. Chris, could you please open the line for questions?

Operator

Our first question is from Mike Ryskin with Bank of America. Your line is open.

John Kim

Hi, good morning. This is John Kim on for Mike.

I wanted to ask about Rejensa®. Could you give us a bit more color on how things have trended compared to your expectation of doubling sales in 2022 in the current inflationary environment? And if you could update us on what your high-level outlook is for '23 and long term, that would be great.

Daniel Bendheim

Hi, John. This is Dani Bendheim. Thanks for the question.

Last year, Rejensa, as we guided towards, doubling sales year over year, and we achieved that. Embedded in this year's guidance is that we're looking to double sales again. So, I do think that we have seen a little bit of slowness at the vet that I think other companies have reported as well. Rejensa has the advantage, I guess, of still being in early innings. So, despite the fact that there might be a little bit a macro slowdown, there's plenty of opportunity for us and we are seeing our momentum continue to build, and we feel pretty good about that number for the year.

John Kim

Great. And on the African swine fever, do you have any expectations, or what are your expectations for Fiscal 2023 on that in China?

Jack Bendheim

Well, as you know from everything you follow, African swine fever has not been solved. The Chinese have done a much better job in biosecurity. But the problem exists both in China and the Far East, and interestingly we are seeing it more and more in Europe in some of the wild pigs that are being caught. But the potential of outbreaks are there all over the place. And so far, there has not been a vaccine at all. So we're continuing on developing a raw vaccine. It's been difficult. I think, as we said before, to get our people into China, reallyI would say not just difficult, impossible, because of the COVID restrictions. So, it slowed down our development, but we continue to remain optimistic that we may have a solution to the problem, and as such, we continue to develop.

John Kim

Thank you, appreciate that.

Operator

The next question is from Erin Wright with Morgan Stanley. Your line is open.

Justin Wang

Hi, everybody. This is Justin Wang on for Erin. Thanks for the questions.

We were wondering if you can go over the underlying livestock market trends across the varying geographies, especially for the U.S. for the Animal Health business, and what you're seeing there? And I have a follow-up.

Jack Bendheim

That's a short question, but it requires hours of answers. Overall, what we're seeing around the world is a strong livestock business. I mean, as you know from what you're reading, prices are up across the board in sort of every market and the consumers continue to pay the prices. So we're not seeing a slowdown, and that's reflected in our sales, again, across the world, across the markets we're in. I mean, there are unusual factors that you have to add in, which for example, is an increasing drought in the United States. So, on the cattle side, there is an increase in slaughter. There's less animals raised on grass, and more on feedlots. As you can understand, the nature of our businesses, the more on feedlots, the better it is for us. But that might come to an end six months or a year from now. But you can't tell. And again, it's a global business. So what we see reflected in the U.S. might be reflected in a different way down in Brazil.

As I said, based on what we're seeing in our sales and the markets we're in, business for the Animal Health industry continues to be good.

Justin Wang

Okay, that's helpful, thank you. And just on the guidance here, what does your guide currently assume in terms of price realizations for the year? And we were wondering if you could speak a little bit more on the incremental investments that you're making for the year, and what that entails. Thanks.

Damian Finio

All right. Thanks for the question, Justin. So I can take that one.

In terms of our guidance, as I mentioned, sales, 2% to 6% growth next year. It'There's really two parts to that: continued strong demand across all segments and regions, and then the annualization of the Fiscal Year 2022 price increases, so we'll see a full year of that in 2023. If you remember, last year, we spoke, I think it was the second quarter or maybe it was the first quarter earnings call, we said that we took pricing action but that they lagged behind cost increases. So we expected most of that favorable impact in the second half of Fiscal Year 2022, which ended up being true. Our margins going forward in Fiscal Year 2023 are consistent with what we realized in the actual numbers in Fiscal Year 2022. So, if you think about that, it implies that with the price increases that we've taken and the annualization of those in Fiscal Year 2023, we'll be keeping up with the cost increases.

In terms of the strategic investments that you mentioned, again, those will continue to be reported in the the corporate business segment. The investments are—there's a pretty good spread across different types of projects. So I would say it's a diverse portfolio. Most of the concentration is in our three growth drivers for Fiscal Year 2023 and overthe medium term, which is vaccines, companion animals, and nutritional specialties.

Justin Wang

Thank you very much. Appreciate that.

Operator

We have no further questions at this time. I'll turn it over to Mr. Finio for any closing remarks.

Damian Finio

All right. Thank you, Chris.

I want to reiterate what Jack said to start the call, which is a thank you again to our employees for enabling Phibro to achieve such strong financial performance in Fiscal Year 2022.

We appreciate you taking the time today to join our call, and for your continued interest in Phibro Animal Health Corporation. On behalf of Jack, Dani, the rest of the Executive Management Team, we are excited about the opportunities that Fiscal Year 2023 presents and the investments that we're making in our future. We hope you enjoy these last days of summer. Thanks again, and have a great rest of your day.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating.