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Phibro Animal Health Corp. (PAHC)

Q1 2023 Earnings Call

CORPORATE PARTICIPANTS

Damian Finio, *Chief Financial Officer*

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

Daniel Bendheim, *Director and Executive Vice President, Corporate Strategy*

CONFERENCE CALL PARTICIPANTS

Erin Wright, *Morgan Stanley*

Wolf Chanoff, *Bank of America*

Balaji Prasad, *Barclays*

PRESENTATION

Operator

Welcome, everyone, to the Phibro Animal Health Corp. First Quarter 2023 Conference Call.

I would now like to turn the conference over to Damian Finio, Chief Financial Officer. Please go ahead.

Damian Finio

Thank you, Regina.

Good morning and welcome to the Phibro Animal Health Corp. earnings call for our fiscal first quarter, ended September 30, 2022. My name is Damian Finio, and I'm the Chief Financial Officer of Phibro Animal Health Corp. I'm joined on today's call by Jack Bendheim, Phibro'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 first quarter and provide an update on 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, pahc.com. Also, on the Investors section of our website, you will find copies of the earnings press release and first 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 expense is separately reported in the consolidated statements of operations, including foreign currency gains, 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 Phibro's first quarter financial performance and guidance for our Fiscal Year 2023.

Jack?

Jack Bendheim

Thank you, Damian, and good morning, everyone.

Our first quarter net sales reflect year-over-year growth of 8% driven by 10% sales growth in both our Animal Health and Mineral Nutrition segments, underpinned by strong growth in our largest regions in the United States, and Latin America & Canada.

Our business is strong, but macroeconomic and operational challenges persist. Supply chain disruptions are less common but still occur. As we previously discussed, we have experienced COVID-related labor and logistical challenges with a key supplier, which internally led to delayed sales and costlier shipments. We were successfully resolving these challenges before quarter end, although not before they had an unfavorable impact on the Adjusted EBITDA contributed by our Animal Health segment.

In addition, sustained inflation is keeping our input cost high, which presents itself in our financial results as lower margins and higher inventory carrying values. To mitigate the risks these challenges present, we will continue raising prices subject to normal competitive conditions, managing discretionary spending, and carrying inventory required to support sales growth. We are overall bullish on our business and our ability to grow sales with both our current portfolio and the pipeline we are developing.

Looking beyond these challenges, we are anticipating further benefits from our strategic investments. Our vaccines and nutritional specialties product line fuel current growth. With our vaccines, new registrations will open new markets for our products in the second half of our Fiscal year, and we expect to bring another autogenous vaccine facility online in Brazil, similar to the facility we have today in Omaha, Nebraska.

With our nutritional specialty products, we just received approval in Brazil to manufacture some of the products we have historically produced only at our Osprey plant in Florida, which allows us to leverage our production capabilities more fully at both locations.

Lastly, on companion animals, we've licensed a pain product for dogs that's in development. While our companion animal projects continue to progress as planned, at this point, with five active and named opportunities in the pipeline, we have reached our goal of having a meaningful portfolio of companion animal development projects.

Finally, we are reiterating our Full Year 2023 net sales guidance of $960 million to $1 billion with Adjusted EBITDA guidance of $113 million to $118 million. However, due to rising interest rates and total debt as

well as unfavorable changes in tax regulations, we're revising guidance on net income, diluted EPS, adjusted net income, adjusted diluted EPS and the adjusted effective tax rate.

As I'm sure you're aware, everyone is navigating through a dynamic and complex operating environment, and we're facing an economic period that many suspect will more than likely worsen before it improves. Despite these short-term uncertainties, we, as I said, remain bullish on our business and our ability to drive profitable growth.

Now I'll ask Damian to review our financial performance for the first quarter and Fiscal Year 2023 guidance in more detail before opening the line for questions.

Damian?

Damian Finio

Thank you, Jack, and let's go to Slide 4. I will start with consolidated financial performance and then cover segment-level performance, capitalization metrics and conclude with a review of our revised financial guidance for the full Fiscal Year 2023.

Consolidated net sales for the quarter ended September 30, 2022, were $232.5 million, reflecting a $17.9 million or 8% increase over the same quarter one year ago. This increase was driven by improvement in both the Animal Health and Mineral Nutrition segment, offset by a slight decline in Performance Products in comparison to a very strong performance in the same quarter last year.

GAAP-based net income and diluted EPS decreased 41% driven by higher SG&A expenses, interest expense, and foreign exchange losses, offset by favorable gross profit and lower income tax expense. After making our standard adjustments to GAAP results, including acquisition-related items, foreign currency movements, and one-offs, first quarter Adjusted EBITDA was comparable to the prior year's quarter driven by higher Adjusted EBITDA in both the Mineral Nutrition and Performance Products segments, offset by lower Animal Health Adjusted EBITDA and an increase in corporate expenses. Adjusted net income and adjusted diluted EPS declined 18%, respectively, driven by higher SG&A expenses and taxes, offset by higher gross profit.

Moving to segment-level financial performance on Slide 5. I'll start with first quarter financial performance for our largest segment, Animal Health, which includes three product lines, namely MFAs and other, nutritional specialties and vaccines. The Animal Health segment posted $154.9 million of net sales for the quarter, which represents an increase of $13.9 million or 10% versus the same quarter prior year. Within the Animal Health segment, we reported a $9 million or 11% increase in MFAs and other versus the same quarter prior year driven by increased sales of processing aids used in the ethanol fermentation industry, $3.1 million or 8% growth in nutritional specialties, which was driven by higher demand for dairy products, and lastly, a $1.8 million or 8% improvement in vaccine net sales driven by increased domestic demand.

In terms of profitability for the segment, Animal Health Adjusted EBITDA was $27 million, a 2% decline from the same quarter prior year and a 220-basis point decline in Adjusted EBITDA margin due to higher SG&A expenses, partially offset by an increase in gross profit.

Moving on to first quarter financial performance for our other business segments on Slide 6. Let's start with Mineral Nutrition. Net sales for the third quarter were $59.6 million, an increase of $5.2 million or 10% 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 $5.3 million, reflecting year-on-year growth of $0.8 million or 17% and reflects an improvement in Adjusted EBITDA margin of 60 basis points driven by increased gross profit derived from the higher average selling prices.

Looking at our Performance Products segment. Net sales of $18 million for the three months ended September 30, 2022, reflects a $1.2 million or 6% decline versus a strong first quarter in the prior year.

Comparatively speaking, this year, we realized lower demand for copper-based products, but at higher prices, partially offset by higher volumes of ingredients for personal care products. Adjusted EBITDA was $2.4 million, an 11% increase and reflective of a 200-basis point improvement in Adjusted EBITDA margin.

Lastly, corporate Adjusted EBITDA declined 5%; or said a different way, corporate expenses increased 5% year-on-year driven by net changes in costs related to but not limited to employees, professional fees, technology, and strategic investments.

Turning to our key capitalization-related metrics on Slide 7. Free cash flow for the 12-month period ending September 30, 2022, was a negative $21 million and was comprised of operating cash flow of $17 million, less $38 million of capital expenditures. In the first quarter, we had a significant and planned seasonal inventory build, which is typical and driven primarily by our Mineral Nutrition business based in Quincy, Illinois, where an adequate level of inventory is needed to minimize logistical issues presented when the Mississippi River freezes.

I wanted to note that the $38 million of capital expenditures excludes a $15 million purchase of property related to our Performance Products segment in California. We have been leasing this land and office building, which is adjacent to our site, for several years, but decided to purchase the property in Q1 when it went on the market for sale. In our opinion, now owning the property maximizes the value of our site, both from an operational and land value perspective.

Our gross leverage ratio, calculated by dividing total debt of $468 million by trailing 12-month Adjusted EBITDA of $111 million, was 4.2 times at the end of the first quarter. It's worth noting that for covenant purposes we use net leverage as defined in our credit agreement.

In terms of liquidity, we had $163 million available at quarter end. This includes cash and short-term investments of $86 million plus $77 million of unused and available revolving credit. After quarter end, we executed a credit agreement amendment, which increased our unused and available revolving credit facility by $60 million, subject to the same leverage ratio limitations as contained in the initial credit agreement. While we have no specific plans to access this incremental credit availability today, we believe that this was a prudent action to take given current uncertainty in the financial markets.

Turning to dividends, consistent with the past several quarters, we paid a quarterly dividend of $0.12 per share or $4.9 million in aggregate. Lastly, I wanted to highlight that $300 million of our $468 million of gross debt is not exposed to rising interest rates, because in early Calendar Year 2020, we secured an interest rate swap at a fixed LIBOR rate of 0.62%. The variable interest expense paid on the remaining $168 million of total debt is subject to rising interest rates, although offset somewhat by interest income earned on short-term investments.

I also want to make mention that with the amendment to the credit agreement executed after quarter end, we began the process of transferring our credit agreement and interest rate swap agreement from LIBOR to SOFR, or the secured overnight financing rate. As I'm sure many of you are aware, LIBOR settings on U.S. debt facilities are scheduled to cease at the end of June 2023.

To summarize, our goal is to end our Fiscal year with less debt and improved gross and net leverage ratios in comparison to what we reported at the end of our first quarter.

Now let's turn to Slide 8, which lays out the revisions we made to our guidance for fiscal year ending June 30, 2023. As Jack mentioned earlier, we are reiterating guidance for net sales of $960 million to $1 billion and Adjusted EBITDA guidance of $113 million to $118 million while revising guidance for net income, diluted EPS, adjusted net income, adjusted diluted EPS, and our adjusted effective tax rate. The adjustments reflect increased interest expense net due to higher interest rates and debt outstanding, and the projected impact of recently released final tax regulations that eliminate U.S. creditability of the Brazil income tax beginning with our current fiscal year, which in turn will increase our U.S. federal GILTI tax liability.

The financials we are revising are as follows: net income, lowering from a range of $45 million to $49 million to a range of $39 million to $43 million; diluted EPS, lowering from a range of $1.11 to $1.21 to a range of $0.96 to $1.06; adjusted net income, lowering from a range of $52 million to $56 million to a range of $49 million to $53 million; adjusted diluted EPS, lowering from a range of $1.28 to $1.38 to a range of $1.21 to $1.31; and lastly, given the changes in tax regulations, we are raising our Fiscal Year 2023 adjusted effective tax rate from 30% to 33%. Guidance for GAAP measures assumes actual foreign exchange losses for the quarter ending September 30, 2022, and the Company's projected foreign exchange rates for the nine months ending June 30, 2023.

In closing, this is a challenging environment for both an operating and an economic perspective. We are very confident in the demand for our products around the world, and we look forward to seeing some of the other opportunities that Jack highlighted in his opening remarks coming to fruition this fiscal year.

With that, Regina, could you please open the line for questions?

Operator

Our first question will come from the line of Erin Wright with Morgan Stanley. Please go ahead.

Erin Wright

Great. Thanks. Thanks for taking the question.

I would like to know what's embedded in your Fiscal '23 guidance now as it relates to price and your ability to take price in the coming quarters, how are you thinking about that dynamic?

Damian Finio

I'll start, and then hand it over to Jack.

As I mentioned, we reiterated our guidance for sales. We continue to take pricing actions in markets when and where we can as competitive conditions allow. We started that process last Fall, about this same time last year, and this will continue this year. We'll continue to raise prices because we're seeing higher input costs, which is reflected in our tighter margins and higher inventory carrying values.

Jack Bendheim

I'm going to add to that. We're in a competitive environment around the world, but there are opportunities as everyone else is facing inflationary costs as well. We will—we have—there's no set number, as Damian said, we will opportunistically raise prices where we can.

Erin Wright

Okay. Got it. then could you just give us a general update on fundamentals across your key livestock categories, including dairy, ruminant, swine, poultry and aqua and how those are trending, what you're most optimistic about in the coming quarters in terms of fundamental demand trends and areas where we'll kind of keep an eye on?

Jack Bendheim

Overall, the animal protein business, notwithstanding the growing recession, is doing well. In the markets we're in, we are seeing strong demand, as reflected in our sales, sort of across the board. I wouldn't point out any single segment. The segment, I would say, that everyone knows is doing sort of worse is the U.S. cattle business, which is a part of the business where we are not that active.

Our cattle business in Brazil is doing quite well, and that seems to be—and that's growing. I wouldn't point out any one segment. Again, overall, as we've often said for a long time, people tend to eat – it's the last thing you give up, and that's sort of reflected in our business.

Erin Wright

Got it. Thank you so much.

Operator

Our next question will come from the line of Michael Ryskin with Bank of America. Please go ahead.

Wolf Chanoff

This is Wolf Chanoff on for Mike. Thanks for taking the question.

I'm wondering if you can give a bit more color on how sales of Rejensa trended in the context of your target of doubling sales year-over-year. We're hearing a lot from others in our animal health coverage about vets having pretty severe labor shortages and staffing challenges. I'm just wondering if you can talk to your experience in launching a new product for the vet channel against that backdrop?

Daniel Bendheim

I'll take it. It's Dani.

You mentioned the guidance we gave was to double sales year-over-year. In Q1, we were, from a sales perspective, a little bit short of that. We were very high double digits, not enough that makes us think we won't hit our full year goal. I think, just anecdotally, we did see a little bit of a slowdown relative to the pace that we were going on so—which very well may be reflected. We obviously don't have the same level of exposure as some of the competitors that you're mentioning that talked about the vet challenges; still, a strong high double-digit growth, perhaps sequentially a little bit of a slowdown quarter-over-quarter.

Wolf Chanoff

Got it, then one slightly more technical one. Can you give us a little more color on the Brazilian income tax law change you flagged? Should we be assuming 33% is a fair baseline going forward for your tax rate? Or are there ways that you can offset this over time?

Damian Finio

Yes. I'll take that one.

As I mentioned, the adjusted effective tax rate in our guidance increased from 30% to 33%, that's on the heels of changes in actual U.S. federal tax legislation, which now disallows the income tax that we pay on Brazilian earnings in the high-tax exception category; without that country included in the category, that translates into a higher calculation of GILTI tax in our federal U.S. tax liability, which overall has a net impact of three percentage points on the tax rate because we have a pretty sizable operation in Brazil and generate a decent portion of our taxable income globally in the Brazilian market. We are looking for ways not just to decrease tax in Brazil or the U.S., but really around the world, and continue to try to find opportunities where we can do so.

Wolf Chanoff

Got it. Much appreciated. Thanks for the questions.

Operator

Our next question will come from the line of Balaji Prasad with Barclays. Please go ahead.

Balaji Prasad
Hi. Good morning. This is Balaji Prasad on for Balaji. Thanks for taking our question.

Actually could you add any additional color and updates on the deal with Rejuvenate Bio? Thank you so much.

Daniel Bendheim

Good morning. It's Dani again.

We have nothing new to add from last quarter. We still believe that they could file—they're anticipating filing for a conditional license by the end of next calendar year.

Balaji Prasad
Got it. Could you add some color on your thoughts on the livestock trend?

Jack Bendheim

We don't have much exposure to that business, but it's all tied into a lot less rain, a lot less pasture, higher cost with feed generated by the conflict there in Europe; overall, it's a lot of money to put—into the feed line, so there is a quickening of taking these cattle forward, which means less cattle, which means less products being sold.

Balaji Prasad
Got it. That's very helpful.

Operator

We have no further questions at this time. I'll turn the conference back over to Damian for any closing remarks.

Damian Finio

Okay. Thank you, Regina, and thank you, everyone, for listening in on today's call. We appreciate your time, attention, interest and support of Phibro Animal Health Corporation, please have a great rest of your day and enjoy the upcoming holiday season.

Thank you.

Operator
Ladies and gentlemen, that will conclude today's call. We thank you all for joining.