Corrected Transcript



Phibro Animal Health Corporation Nasdaq:PAHC

Earnings Call

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Call Participants

EXECUTIVES

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Chief Financial Officer

Jack Clifford Bendheim
Chairman, President & CEO

Daniel Bendheim
Director & Executive Vice President, Corporate Strategy

ANALYSTS

Brian Michael Wright
ROTH Capital

Balaji Prasad
Barclays Capital

Erin Wright
Morgan Stanley

Michael Ryskin
Bank of America

Presentation

Operator

Good morning. My name is Jeannie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Phibro Animal Health Corporation Q2 Fiscal Year 2023 Conference Call.

Damian Finio, Chief Financial Officer, you may begin your conference.

Damian Finio
Chief Financial Officer

Thank you, Jeannie. Good morning, and welcome to the Phibro Animal Health Corporation Earnings Call for our Fiscal year 2023 Second Quarter ended December 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, 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 second quarter and share our current thinking on financial guidance for the 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 links to the earnings press release and second quarter Form 10-Q filed with the SEC yesterday as well as the transcript and slides discussed and presented on this morning's 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 disclosure notice marked forward-looking statements 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, other income expense is separately reported in the consolidated statements 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 perspective on Phibro's second quarter financial performance and guidance for our fiscal year 2023. Jack?

Jack Clifford Bendheim
Chairman, President & CEO

Thank you, Damian, and good morning, everyone. Our top line continues to grow. Second quarter net sales of $245 million reflects growth of 5% over the same quarter last year. This improvement was driven by 9% and 37%sales growth in our Animal Health and Performance Products segments, respectively, offset by an 8% decline in Mineral Nutrition.

In our core business segment, Animal Health, we reported our seventh consecutive quarter of year-over-year quarterly sales growth in each of our 3 major product categories. On a calendar year basis, this translates into sales growth of more than 20% in 2022 over 2020, which relative to some industry reports, puts us in the top tier of animal health companies.

Our Mineral Nutrition business was down year-over-year primarily reflecting the lower value of the underlying commodity minerals such as copper that drives this business. Our Mineral Nutrition business is also the one area where we have exposure to the U.S. feedlot industry, where we are seeing fewer cattle placements as compared to the same quarter last year.

In terms of sales by region, we realized 12% growth in Latin America and Canada and 7% growth here in the United States while markets in Europe, the Middle East, Africa and Asia Pacific declined due primarily to the lingering effect of COVID-19 and persistent economic challenges. Overall, we posted a strong financial performance for the first half of our fiscal year with an even stronger projected second half.

I also want to share that we add companion animal experience to our Board of Directors. On Monday we announced Alejandro Bernal, the newly appointed President and CEO of PetDx, joined our Board. Alejandro is a former executive at Mars Veterinary Health and worked in senior positions at Zoetis. We welcome his insights and believe they will be particularly impactful with respect to our companion animal business, which we seek to meaningfully grow over the coming years as we continue to focus on progressing our pipeline of projects in development and on growing Rejensa®.

Looking beyond Phibro, the global economy is showing signs of improvement, but there are still challenges. The improving trend of the consumer price index is encouraging, but of course, for margins to improve, input costs will need to decline, and we will need to work through higher priced inventory on hand. We are focused on maintaining continuity of supply, which has resulted in us adding about one month of inventory in order to mitigate the risk of supply chain disruptions impacting our ability to get products to our customers on time.

In the months to come, as we rebuild our confidence in the supply chain, we will look to bring inventory levels down, which in turn should help to improve our operating cash flows. And we continue to focus on raising prices where market conditions allow.

I remain bullish on our business and our ability to grow sales given the strong demand for our current portfolio of products and the projected demand for the pipeline of future nutritional specialty, vaccine and companion animal products we have in development.

Finally, we are reiterating our full fiscal year 2023 net sales guidance of $960 million to $1 billion, and adjusted EBITDA guidance of $113 million to $118 million. However, to reflect the unfavorable impact of the tax-adjusted nonoperational environmental remediation costs charged to the P&L in the second quarter, we lowered guidance for GAAP net income and GAAP diluted EPS. Damian will explain these charges in more detail, but I also encourage you to read our updated disclosures included in our latest Form 10-Q.

Overall, I am pleased with our second quarter and first half performance. Our full year guidance implies an even stronger second half of fiscal year 2023. But these projections are achievable and consistent with how our financial performance played out last fiscal year. Like you, we are hopeful that the global economy will continue to improve. But irrespective of the global backdrop, I remain bullish on Phibro and our opportunities to drive growth.

Now, I'll hand it over to Damian to review our second quarter financial performance and fiscal year 2023 guidance in more detail before opening the line for questions. Damian?

Damian Finio
Chief Financial Officer

Thanks, Jack. Let me start with consolidated financial performance on Slide 4, then cover segment level financial performance, key capitalization metrics and conclude with a review of our financial guidance for the full fiscal year 2023.

Consolidated net sales for the quarter ended December 31, 2022, were $244.6 million, reflecting an $11.9 million or 5% increase over the same quarter one year ago. This increase was driven by improvement in both the Animal Health and Performance Products segments, offset by a decline in Mineral Nutrition.

GAAP-based net income and diluted EPS decreased 59% driven by higher SG&A and interest expense, offset partially by lower income tax expense, but primarily due to a $6.6 million charge pretax, orcloser to $4 million after tax, charge to the P&L in the second quarter.

Most but not all of these charges relate to a tentative settlement of a lawsuit filed in 2014 seeking contribution from PhibroTech and one of our other subsidiaries which are included in our Performance Products segment and several other parties towards past and future costs associated with the investigation and remediation of a regional groundwater plume affected by the Omega chemical site, which is upgradient of our PhibroTech facility in Santa Fe Springs, California.

In January 2023, the plaintiffs in the lawsuit, Environmental Protection Agency and certain defendants, including PhibroTech, reached a tentative settlement that would provide for a "cash out" settlement with contribution protection, which would release PhibroTech and its affiliates from liability for contamination of the groundwater plum affected by the Omega chemical site, with certain exceptions.

The tentative settlement would also resolve claims asserted by the EPA in August 2022 for its unrecovered past and future response costs related to the Omega groundwater plume as well as claims for indemnification and contribution between PhibroTech and the successor to the prior owner of the PhibroTech site. You can find further details on our second quarter Form 10-Q in Footnote 7 "Commitments and Contingencies" under the subheading, "Environmental".

And in addition to the increase in the environmental reserve related to the ground water plume affected by the Omega chemical site, we adjusted the reserve for other nonoperational environmental remediation costs relating to contamination of the PhibroTech site that also pre-dated our ownership.

After results for one-offs on nonrecurring and/or nonoperational costs, including the environmental costs I just discussed, acquisition-related items and foreign currency movements. Consolidated adjusted EBITDA increased $1.8 million or 6% in comparison to the prior year's quarter driven by higher adjusted EBITDA in both the Animal House and Performance Products segments, offset by lower Mineral Nutrition adjusted

EBITDA, an increase in Corporate expenses.

Adjusted net income and adjusted diluted EPS decreased 9%, respectively, driven by higher SG&A expenses and taxes, offset by higher gross profit.

Moving on to Slide 5, segment level financial performance, I'll start with second quarter financial performance for our largest segment, Animal Health, which includes 3 product lines, namely MFAs and others, nutritional specialties and vaccines. The Animal Health segment posted $163.8 million of net sales for the quarter, which represents an increase of $12.9 million or 9% versus the same quarter prior year.

Within the Animal Health segment, we reported

- a $5.5 million or 6% increase in MFAs and other versus the same quarter prior year, driven by increased demand for MFAs in Latin America and processing aids used in the ethanol fermentation industry.
- A $6.5 million or very strong 17% growth in nutritional specialties driven by higher domestic demand and selling prices for dairy products, along with growth in Rejensa®.
- And lastly, a $0.9 million or 4% improvement in vaccine net sales, driven by increased demand.

In terms of profitability for the segment, Animal Health adjusted EBITDA was $37.1 million, a 10% improvement over the same quarter prior year due to higher gross profit on higher sales and margin improvement, partially offset by an increase in SG&A. And adjusted EBITDA margin for the segment improved 30-basis points to 22.6%.

Moving on to second quarter financial performance for our other business segments on Slide 6. Let's start with Mineral Nutrition.

Net sales for the third quarter were $61.6 million, $2 million more than the prior quarter, but a $5 million or 8% decline versus the same quarter prior year, driven by a decrease in demand for trace minerals, a consequence of some customers lowering post-COVID inventory levels to adjust for the impact of heat and drought in the U.S. Midwest on feed intake as well as other economic Challenges partially offset by higher average selling prices, which are correlated with the movement of the underlying raw material costs.

Mineral Nutrition adjusted EBITDA was $4.4 million, reflecting a decline of $1.1 million or 20%, driven by lower gross profit. Adjusted EBITDA margin for the segment was 7.1%, a 120-basis point decline versus the same quarter prior year.

Looking at our Performance Products segment, net sales of $19.2 million reflects a $4.1 million or healthy 27% improvement, driven primarily by increased demand for copper-based products and higher average selling prices for copper-based products and ingredients for personal care products.

Adjusted EBITDA was $2.3 million, a 73% increase and reflective of a 310-basis point improvement in adjusted EBITDA margin.

Lastly, Corporate adjusted EBITDA declined 12% or said differently, corporate expenses increased 12%, driven by increased costs related to employees and strategic investments.

Turning to key capitalization-related metrics on Slide 7. Free cash flow for the 12-month period ending December 31, 2022, was a negative $45 million and was comprised of trailing 12 months of negative operating cash flow of $5 million less $40 million of capital expenditures.

It's important to note that the $40 million of capital expenditures excluded a first quarter $15 million purchase of property. Although for GAAP reporting, this purchase is categorized as capital expenditures on the consolidated balance sheet and statement of cash flows, it was financed with the 2022 term loan referred to in the “other long-term debt” footnote included in our second quarter Form 10-Q and therefore excluded here.

The negative $45 million in free cash flow for the 12 months ended December 31, 2022, was driven

primarily by a $58 million increase in inventory over the same period representing approximately one month of additional inventory on hand, which is intended to mitigate the risk of supply chain disruptions which impact the Company's ability to fulfill customer orders on a timely basis.

Consistent with the projections we communicated on our last call, operating cash flow for the second quarter reflected a $9 million improvement over the first quarter. Although on a trailing 12-month basis, free cash flow declined $24 million versus the last quarter end. This delta relates to the difference between free cash flow for the quarter ending December 31, 2022, that's included in this quarter end's calculation versus the same quarter prior year that is now excluded.

Moving on to liquidity<we had $202 million of liquidity available at quarter end. This includes cash and short-term investments of $78 million, plus $124 million of unused and available revolving credit, subject to the same leverage ratio limitations as defined in the 2021 loan agreement.

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

Turning to leverage, our gross leverage ratio at quarter end was 4.2x, consistent with last quarter end. This is calculated by dividing total debt of $477 million by trailing 12-month adjusted EBITDA of $113 million. It's worth noting that this is not the leverage ratio used to determine financial covenant compliance. For covenant compliance, we calculate a net leverage ratio as defined in the 2021 loan agreement.

And lastly, I wanted to highlight that $300 million of our $477 million of gross debt is not exposed to current market interest rates. We have an interest rate swap in place, which has now been fully converted from LIBOR to SOFR, the secured overnight financing rate, at a fixed SOFR rate of 0.61%. The variable interest expense paid on the remaining $177 million of total debt is subject to rising interest rates but is partially offset by interest income earned on short-term investments.

Now let's turn to Slide 8, which lays out the revisions we made to our GAAP guidance for fiscal year ending June 30, 2023. As Jack mentioned, in addition to reiterating guidance for net sales of $960 million to $1 billion, and adjusted EBITDA guidance of $113 million to $118 million. We are reiterating guidance for adjusted net income, adjusted diluted EPS and our adjusted effective tax rate.

However, we are lowering guidance for GAAP net income and GAAP diluted EPS to reflect the unfavorable impact, net of tax, of the nonoperational environmental tentative litigation settlement and remediation costs charged to the P&L in the second quarter.

That said, let me summarize where we now stand for our full year guidance. We are projecting net sales of $960 million to $1 billion, no change. Net income of $34 million to $38 million, which is a reduction from the $39 million to $43 million range previously communicated and reflective of the after-tax effect of the $6.6 million of environmental cost charges to the P&L in the second quarter.

Because of the reduction in net income guidance, diluted EPS guidance now stands at $0.84 to $0.94, which is a reduction from the $0.96 to $1.06 range previously communicated.

Adjusted EBITDA of $113 million to $118 million, again, no change.

Adjusted net income of $49 million to $53 million, which is unchanged.

Adjusted diluted EPS of $1.21 to $1.31, also unchanged.

And lastly, an estimated adjusted effective tax rate of 33%, again, no change.

Guidance for full year GAAP metrics assumes actual foreign exchange losses for the 6 months ending December 31, 2022, and the company's projected currency exchange rates for the next 6 months for the 6 months ending June 30, 2023.

In closing, we're pleased to report that our second quarter and first half adjusted financial performance was in line with our expectations. And as our full year guidance implies, we are projecting and looking forward to an even stronger second half.

So with that, Jeannie, could you please open the lines for questions?

Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Brian Wright with ROTH MKM.

Brian Michael Wright
ROTH MKM Partners, LLC, Research Division

I have one and a follow-up, if possible. Just -- and I apologize if I missed this, but could you provide a little quantification between the higher SG&A between employee costs and strategic investments? Or any color around that?

Damian Finio
Chief Financial Officer

Yes. I could take that question. So, on the employee cost, we had vacancies last year that we were able to fill this year, given the free up in the labor market, that's what's driving the higher employee costs. It's a combination of the number of people as well as the cost per labor hour.

On the strategic investments, as I think we mentioned in our guidance earlier in the year, our intent was to spend about an additional $10 million. A good portion of that is allocated to our companion animal development pipeline, but also our development projects for vaccines and nutritional specialists.

Brian Michael Wright
ROTH MKM Partners, LLC, Research Division

And think about that kind of ratably over the new year. Is that kind of the way to think about that?

Damian Finio
Chief Financial Officer

In terms of growth in strategic investment spend, second half over first half, we expect a slight increase in the second half of the year, but that's baked into our guidance.

Brian Michael Wright
ROTH MKM Partners, LLC, Research Division

Great. And then on the follow-up. With the additional Board member on Alejandro, is -- I understand getting strategic device on competing in the companion animal business, but are there also potential synergies? It seems like there might be synergistic business opportunities between the 2 organizations.

Jack Clifford Bendheim
Chairman, President & CEO

I mean, we just started, I don't believe so. I think we're obviously more concerned about conflicts of interest than we are about synergies. As a matter of fact -- the more synergies, the more conflicts.

Operator

Your next question comes from the line of Michael Ryskin with Bank of America Securities.

Bo
Bank of America

This is Bo on for Mike. So, I wanted to start with a high-level one. Phibro's Animal Health business continues to post fairly impressive results relative to the livestock divisions to some of your peers. Can you talk to what's allowing your Animal Health business to do so well in the current environment? Is it a function of portfolio in species mix? Or are there other factors that we should be considering here?

Jack Clifford Bendheim
Chairman, President & CEO

It's just great management.

Bo
Bank of America

Fair enough. I can't argue with that.

Jack Clifford Bendheim
Chairman, President & CEO

Yes. But I think it's literally where we're positioned in the market and the products that we've developed, especially concentrating on the changes that happened in the history when antibiotics came out. I said often that the antibiotics came out, but no one told that to the bacteria. So, bacteria is still there, and we've done a great job. Our team has done a great job in developing non-antibiotic products, mostly nutritional specialties and vaccines, that help control that bacteria and help the farm in raising the animals in a healthy way.

Bo
Bank of America

Got it. And just as a follow-up, you noted seeing some weaker feedlot placements. Can you talk to what you're seeing more generally in the market? And are you expecting this to kind of persist for as long as we see the drought persist? Or are there other things going on there?

Jack Clifford Bendheim
Chairman, President & CEO

Well, there's -- as we mentioned earlier, we don't do a lot of is on the feedlot, but what we are seeing where it has affected us, the drought has forced all the farmers to take animals off the pasture because there wasn't any ability to feed from the pasture and move them faster to the feedlots. So that has been -- in the early first part of the year, sort of an increase.

Now when those animals have been processed, there are fewer animals following them, and that will have, I would say, more of an effect next year than it would have this year. S, it'll have more effect in calendar year 2023 than it had in calendar 2022.

Bo
Bank of America

And then just a last one here. There has been a flurry of recent articles on the impact of the bird flu to the global layer flock. I know that you're not super exposed there, but can you talk to your outlook for the poultry market in general? And has this gotten any worse over recent months given how long it's been going on?

Jack Clifford Bendheim
Chairman, President & CEO

I think the shock in the industry is how long it's persisted. I mean, normally, we've seen avian influenza in the past, but by the summertime, it's gone. And this year, it's not gone in the summertime, and it continues to persist. So, we have seen the effect it's had on the price of eggs given that, that might be -- there might be a consumer pullback and that those prices might start dropping. It's -- so far, it hasn't really hit the broader industry, which is the biggest part of our business, the biggest part of the chicken business. But it's out there, and it's scary.

Operator

Your next question comes from the line of a representative at Barclays.

Vishal

Barclays

This is Vishal for Balaji. We see that one of the important contributing factors for your growth in the MFA business is the growth in Latin America. Do you expect this trend to continue? Or what is your outlook for your MFA and animal health business in Latin America?

Jack Clifford Bendheim

Chairman, President & CEO

We've been investing a while in Latin America and expanding our presence there. And yes, I think we will continue to see growth in those markets relative to what we've done in the past.

[pause]

Damian Finio
Chief Financial Officer

Is there any more in the queue that we can respond to? You may be on mute. We cannot hear your line.

[pause]

So, we will assume there's no more questions for today. We appreciate your time. Thank you for your interest in Phibro Animal Health and have a great rest of your day.

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