

Presentation

Operator

Hello, and thank you for standing by. My name is Regina, and I will be your conference operator today. At this time, I would like to welcome everyone to the Phibro Animal Health Corporation Third Quarter 2023 Conference Call. [Operator Instructions]. I would now like to turn the conference over to Damian Finio, Chief Financial Officer. Please go ahead.

Damian Finio

Chief Financial Officer

Thank you, Regina. Good morning, and welcome to the Phibro Animal Health Corporation Earnings Call for our Fiscal Year 2023 Third Quarter ended March 31, 2023. 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 our third quarter and fiscal year-to-date financial results before opening the lines for your 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 third 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 to you 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 to you 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 and expense as 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 third quarter and fiscal year-to-date financial performance. Jack?

Jack Clifford Bendheim

Chairman, President & CEO

Thank you, Damian, and good morning, everyone. We posted strong fiscal year-to-date sales growth. Our third quarter net sales were \$246 million, which reflects 3% growth over the same quarter last year. Despite the challenging market and economic conditions, our consolidated sales growth has been driven primarily by our Animal Health segment and with well-balanced improvements across our three product categories. Our Animal Health segment has achieved a remarkable 10% year-to-date increase in net sales compared.

to the same period of the previous year. We are unfortunately seeing some signs of recessionary pressure in our Mineral Nutrition segment as our customers are seeking to reduce purchases and lower inventory.

We will take steps over the next few months to ensure our inventory is better balanced for our customers' needs.

Overall, we have posted strong fiscal year-to-date sales growth despite the challenging conditions. We see continued opportunities for growth in our Animal Health segment. As I mentioned, on a year-to-date basis, our Animal Health segment has achieved a 10% increase in net sales compared to last year, and this segment continues to present us with multiple growth opportunities.

We have posted eight consecutive quarters of year-over-year sales growth in each of our three major product categories. From a year-to-date comparative perspective, the product categories of MFAs and other is up 9%, while nutritional specialties are up 12% and vaccines, up 9%. I'm especially pleased with our vaccine growth in Latin America. We recently opened a new autogenous vaccine facility in Brazil and launched commercial poultry vaccines in the region. And regarding the nutritional specialties, we continue to find ways to leverage our product and technologies we acquired with the 2019 acquisition of Osprey Biotechnics. I'm also happy to report that our companion animal's development pipeline continues to progress.

We see Companion Animal as a medium-term growth driver for the company, and we will provide updates as the pipeline progresses. In terms of profitability, on today's portfolio over time, margins should improve as input costs return to historical levels. The Animal Health segment adjusted EBITDA margin was 20.8% for the third quarter, which is a 110-basis point improvement over last year. Although the year-to-date EBITDA margin is still 30 basis points shy versus last year, we see signs that input costs are returning to normal levels. For margin improvements to continue, input costs will each continue to decline, and we will need to work through a higher price inventory on hand. We are taking other actions to manage working capital more closely, which we anticipate will help to improve our free cash flow.

We continue to focus on raising prices when market conditions allow, and we 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. Lastly, Phibro had a strong third quarter. And as we approach our fiscal year-end, we remain confident in our full year guidance. I will now ask Damian to review our third quarter financial performance and fiscal year 2023 guidance in more detail before opening the line for questions.
Damian?

Damian Finio

Chief Financial Officer

Thank you, Jack. I will start with consolidated financial performance on Slide 4, then cover segment-level performance, capitalization metrics and conclude with a review of our financial guidance for the full fiscal year 2023. Consolidated net sales for the quarter ended March 31, 2023, were \$245.7 million, reflecting a \$6.1 million or 3% increase over the same quarter 1 year ago. This increase was driven by improvement in our largest segment, Animal Health, partially offset by declines in Mineral Nutrition and Performance Products. GAAP-based net income and diluted earnings per share decreased 43%, driven by higher SDA,

SG&A and interest expense, offset partially by gross profit improvements and lower income tax expense.

After adjusting GAAP results for one-offs and nonrecurring and/or nonoperational costs such as environmental remediation, acquisition-related items and foreign currency movements, consolidated adjusted EBITDA decreased \$0.6 million or 2% in comparison to the prior year's quarter, driven by lower adjusted EBITDA in our Mineral Nutrition and Performance Products segments, coupled with an increase in corporate expenses, offset by higher adjusted EBITDA in the Animal Health segment.

Adjusted net income and adjusted diluted earnings per share decreased 13%, respectively, driven by higher SG&A expenses and taxes, offset by higher gross profit. Moving to Slide 5, segment level financial performance. I'll start with third 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 \$164.4 million of net sales for the quarter, which represents an increase of \$15.8 million or 11% versus the same quarter of the previous year. Within the Animal Health segment, we reported an \$8.9 million or 11% increase in MFAs and other versus the same quarter prior year, driven by increased demand for MFAs domestically and in the region of Latin America and Canada as well as increased demand for processing aids used in the ethanol fermentation industry. \$3.6 million or 9% growth in nutritional specialties, driven by higher domestic demand and selling prices for dairy products, along with growth in our companion animal product, Rejensa®, and lastly, a \$3.3 million or very strong 15% improvement in vaccine net sales driven by increased demand and new product launches in Latin America.

In terms of profitability for the segment, Animal Health adjusted EBITDA was \$34.2 million, a \$5 million or 17% improvement over the same quarter of the prior year due to higher gross profit on higher sales, partially offset by an increase in SG&A, and the adjusted EBITDA margin for the segment improved 110 basis points to 20.8%. 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 \$62.9 million, a \$6.1 million or 9% decline versus the same quarter prior year driven by a decrease in demand for trace minerals. The consequence of customers lowering inventory levels in the face of 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 \$3.9 million, reflecting a decline of \$3.4 million, driven by lower gross profit. The adjusted EBITDA margin for the segment was 6.1%, a decline from the prior comparative period. Looking at our Performance Products segment. Net sales of \$18.3 million reflects a \$3.7 million decline driven primarily by decreased demand for copper-based products and personal care products, partially offset by higher average selling prices, correlated with the movement of the underlying raw material costs.

Adjusted EBITDA was \$2.4 million, down in terms of dollars versus the comparative period, but reflective of a 20-basis point improvement in adjusted EBITDA margin. Lastly, corporate adjusted EBITDA declined 15% or said differently, corporate expenses increased \$1.7 million or 15%, driven by the intentional increased spend on strategic investments. Turning to key capitalization-related metrics on Slide 7. Free cash flow for the 12-month period ending March 31, 2023, was a negative \$43 million, reflecting a slight improvement versus what we reported last quarter and was comprised of trailing 12 months of negative operating cash flow of \$5 million, less \$38 million of capital expenditures. The negative \$43

million of free cash flow for the 12 months ended March 31, 2023, is driven primarily by a \$43 million increase in inventory over that same period, representing slightly less than one month of additional inventory.

As Jack mentioned in his opening remarks, we will be taking steps over the next few months to make sure our inventory is better balanced to the needs of our customers, particularly in our Mineral Nutrition segment. We are taking other actions to more closely manage working capital, which should also help to improve free cash flow moving forward. Consistent with the projections we communicated on our last call, free cash flow for the third quarter reflected a \$10 million improvement over the second quarter. We are encouraged by the improving trend of operating cash flow. And as we continue to focus on cost control, lowering inventories and keeping our accounts receivable current, we project this trend to continue in the fourth quarter.

Note, the \$38 million of capital expenditure excludes the first quarter \$15 million purchase of property, although for GAAP reporting, this purchase is categorized as a capital expenditure 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 Form 10-Q.

Moving on to liquidity. We had \$192 million of liquidity available at quarter end. This includes cash and short-term investments of \$77 million plus [indiscernible] of unused and available revolving credit subject to the leverage ratio limitations 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 4.3x. This is calculated by dividing total debt of \$482 million by trailing 12-month adjusted EBITDA of \$112 million. It's important to highlight that this is not the leverage ratio used to determine covenant compliance. For covenant compliance, we calculate a net leverage ratio as defined in the applicable loan agreement.

And lastly, \$300 million of our \$482 million of gross debt is not exposed to current market interest rates. We have an interest rate swap in place at a fixed SOFA rate of 0.61%. The variable interest expense paid on the remaining \$182 million of total debt is subject to rising interest rates, but it's partially offset by interest income earned on our short-term investments.

Now let's turn to Slide 8 to discuss guidance for the remainder of our fiscal year, which, as a reminder, ends in less than 2 months on June 30, 2023. We are reiterating the fiscal year 2023 financial guidance communicated on our last earnings call in February. To confirm, our full year guidance is as follows: net sales of \$960 million to \$1 billion, net income of \$34 million to \$38 million; diluted earnings per share of \$0.84 to \$0.94. -- adjusted EBITDA of \$113 million to \$118 million, adjusted net income of \$49 million to \$53 million, adjusted diluted earnings per share of \$1.21 to \$1.31 and lastly, an estimated adjusted effective tax rate of 33%.

Guidance for the full year GAAP metrics assumes actual foreign exchange losses for the 9 months ending March 31, 2023, and the company's projected currency exchange rates for the fourth quarter ending June 30, 2023.

Lastly, on Slide 9, the momentum behind our ESG effort continues to build, thanks in large part to the enthusiasm and engagement of our employees. Next week, we intend to publish our second ESG report titled Health at the heart, which reflects the progress made in calendar year 2022. We will issue a press release when the report is made available.

In closing, we are pleased with our third quarter and year-to-date financial performance. Our Animal Health segment growth, despite the challenging market dynamics continues to outperform the market, and we are excited by the variety of opportunities for growth that we see for this, our largest business segment.

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

Question and Answer

Operator

[Operator Instructions]. Our first question will come from the line of Michael Ryskin with Bank of America.

Joseph Wolf Sylvester Chanoff

BofA Securities, Research Division

This is Wolf Chanoff on for Mike. Congrats on the quarter. So, I appreciate you guys flagging the recession and kind of macro impacts that you're seeing in Mineral Nutrition. I'm just wondering how would you describe the possibility that these impacts spread beyond Mineral Nutrition to your broader Animal Health segment, just kind of a range of outcomes around this recessionary impact? And then I have a semi related follow-up.

Jack Clifford Bendheim

Chairman, President & CEO

Thanks for the question, Wolf. I mean we view our business as recession resistant. We've been in the business a long time. We've been through recessions. And effectively, people eating protein is really among the very, very last things to go. I mean -- and we see changes. I mean people might give up steak and go to chicken or some combination. But overall, our business is more tied to population growth and to general wealth, which the recession sort of again, it's sort of recession resistant.

Joseph Wolf Sylvester Chanoff

BofA Securities, Research Division

Got it. I appreciate that. And then -- so sticking with Mineral Nutrition. Last quarter, you called out some kind of choppiness in the U.S. beef cattle feed lots. And I realize that it's only with a small part of your portfolio, but I was wondering if you have any updates on what you're seeing in terms of feedlot dynamics.

Jack Clifford Bendheim
Chairman, President & CEO

So, for this last quarter, it still remains a very small part of our business. But what we're seeing is demand sort of is more driven by the fact of what I spoke about in my opening remarks, that over last year when shipping was so difficult, and people were very concerned about supply chain. There was more of an increase in inventories, both at our customers and ourselves. And the worst thing to do is run out. So, prices were better, volumes are better. And I think as the shipping lines have straightened out and shipping has become less of a problem, less of a concern, there is this big adjustment (to lower inventories). And I think that's a bigger part of this than anything else.

Operator

Your next question comes from the line of Balaji Prasad with Barclays.

Unknown Analyst

This is [indiscernible] on for Balaji. Just a quick one on your Latin American business. China has recently lifted the embargo on the Brazilian beef imports. Do you see this change as a potential tailwind for your Latin America Animal Health business, which had been performing well recently?

Jack Clifford Bendheim
Chairman, President & CEO

So, I think that is among the other tailwinds of Brazil being a phenomenal market and a very big exporter of protein. So, China removing any barriers to commerce is definitely helpful. And the state and the health of the vaccine business as well as the other businesses that we see as continuing to help Latin America, but specifically Brazil in its production and export of protein.

Operator

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

Brian Michael Wright
ROTH MKM Partners, LLC, Research Division

Could you remind us on the capacity of the Brazilian vaccine facility and what that could mean to grow?

Jack Clifford Bendheim
Chairman, President & CEO

So, the facility -- thanks for the question. The facility that we built is a small facility. It's involved with the autogenous vaccine business. This vaccine business is a custom vaccine. We go on farms; we pick up samples-- we try to isolate the viruses and we make a custom vaccine for that. So, it's literally... it's a farm-by-farm business. The prices you get are higher, but I would say it's more effective because we're dealing with farm-by-farm viruses, but it's not a huge volume business. But beyond that, we recently received approval for some of our vaccines that we produce, poultry vaccines that we produced in Israel, and we just started importing to Brazil. So that's a new add to our business there, and that obviously is a much larger business.

Brian Michael Wright

ROTH MKM Partners, LLC, Research Division

Great. And then I just was hoping maybe we could kind of get some visibility on just the underlying like U.S. broiler volumes kind of how they progress from January to now. Are they kind of higher now than they kind of began the third quarter?

Jack Clifford Bendheim

Chairman, President & CEO

The U.S. broiler volumes, I would say, are maybe down, too flat and holding steady.

Brian Michael Wright

ROTH MKM Partners, LLC, Research Division

Okay. And then just same question for maybe Brazilian cattle.

Jack Clifford Bendheim

Chairman, President & CEO

It's -- cattle are not our only focus, even though it's a bigger part of our business in Brazil, I would say Brazil cattle business just remains flat to slightly up.

Operator

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

Damian Finio

Chief Financial Officer

Okay. Thank you, Regina, and thank you, everyone, for participating in today's call. We appreciate your time, attention and interest in Phibro Animal Health Corporation. Have a great rest of your day, and please be sure to check out our second ESG report when it's published next week. Thank you.

Operator

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