

Equity Research

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Phibro Animal Health Corporation (PAHC-\$29.46)

Rating: BUY

Target Price: \$36.00

Strong Quarter and Favorable Sector Trends; Maintain BUY, Raise PT to \$36 from \$27

<u>REV</u>	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>
2014A	162.2A	172.7A	173.3A	183.7A
2015E	187.5A	182.4E	185.7E	197.9E
Prev	173.4E	182.1E	185.3E	197.6E
2016E	—	—	—	—
<u>EPS</u>	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>
2014A	0.12A	0.07A	0.36A	0.22A
2015E	0.51A	0.37E	0.38E	0.40E
Prev	0.34E	0.36E	0.36E	0.39E
2016E	—	—	—	—
<u>FY</u>	<u>2014A</u>	<u>2015E</u>	<u>2016E</u>	
REV	691.9A	753.3E	793.4E	
Prev	—	739.6E	—	
EPS	1.22A	1.67E	1.86E	
Prev	—	1.46E	—	
P/E	24.1x	17.6x	15.8x	

- **1Q:FY2015 performance and industry tailwinds justify our PT raise:** Earlier this week Phibro reported revenues of \$187.5M and adjusted diluted earnings of \$0.51 versus FactSet consensus estimates of \$174.9M and \$0.35. Net sales in the quarter grew 16% Y/Y, and adjusted EBITDA grew 41% Y/Y. Management raised guidance from \$735-755M and \$1.46-1.51 to \$739-759M and \$1.57-1.62 due to acceleration of \$4M in licensing revenue. We are seeing industry trends that we believe represent strong tailwinds to Phibro's business: for example, low feed prices, which leads to investment in heavier animals that require more animal drugs, and increased sector M&A activity. Furthermore, the company expects to start selling additional products into China as well as to benefit from currency trends. We reiterate our BUY rating and raise our PT to \$36 from \$27, which is based on a 15x EV/EBITDA multiple (at a discount to industry leader Zoetis, which trades at a 16.6x EV/EBITDA multiple). Separately, our DCF valuation suggests a hypothetical \$31 PT, which may not incorporate a positive industry outlook, in our view.
- **Continued volume growth across the segments:** Animal Health sales grew by 16% Y/Y, primarily from volume. Within Animal Health, medicated feed additives grew 4% Y/Y (largely driven by expansion into international markets like Latin America and Asia-Pacific), vaccine sales grew 20% Y/Y excluding the effect of the \$6M licensing revenue in the quarter, and nutritional specialties (which includes the dairy immune boosters) grew 38% Y/Y. This segment may drive future upside, in our view. Mineral Nutrition sales grew 20% Y/Y also on volume. Sales within the legacy business "Performance Products" were flat -1% Y/Y.
- **Other updates:** (1) Phibro signed a contract with a distributor in China to market its dairy specialty products and has completed the registration process to sell in that country. Phibro already currently sells its MFAs and vaccine product lines in China and anticipates ramping sales for dairy specialty products, but management would not provide additional growth expectations. (2) Management indicated that the strengthening dollar could represent a tailwind in coming quarters. (3) The animal health industry is getting increased visibility after Pershing Square disclosed a large position in Phibro competitor, Zoetis. We note that the Bendheim family controls 92.5% of Phibro voting power, so activism may be unlikely in this name. (4) Management sees potential for bolt-on acquisitions and has \$19.7M in cash on the balance sheet while paying its ~1% dividend.

Current Statistics

Market Cap (\$Mil)	\$1,147.6	Free Float (%):	17.400
Avg. Daily Trading Volume (3 mo.):	93,133		
Shares Out (Mil):	17.443		

Exhibit 1: Phibro 1Q:FY2015 Variance Analysis

	1Q:15E	1Q:15A	% Variance	Y/Y Growth	Q/Q Growth	Comments
Revenues	173.4	187.5	8.1%	15.6%	2.0%	\$174.9 Consensus
COGS	120.0	127.1	6.0%	12.8%	-1.8%	
Gross Profit	53.4	60.3	13.0%	21.8%	11.1%	
SG&A	34.5	35.2	2.1%	6.4%	-14.5%	
EBIT	18.9	25.1	32.8%	53.1%	91.6%	
Interest Income	0.0	-0.1	-	NM	NM	
Interest Expense	3.7	3.6	-3.2%	-59.5%	-47.8%	
Other Income (Expense)	0.0	-1.2	-	-285.8%	-105.4%	
Pre-tax income	15.2	22.8	49.8%	225.3%	NM	
Income tax expense	2.7	2.3	-14.7%	99.7%	55.9%	
Net income	12.5	20.5	64.0%	250.5%	NM	
Diluted shares	39.2	39.6	1.0%	-42.5%	5.8%	
GAAP EPS	\$0.32	\$0.52	62.4%	510.0%	NM	
Adjusted non-GAAP Income	\$16.1	\$22.7	40.9%	160.2%	41.8%	
Total Tax	\$2.7	\$2.4	-10.9%	264.1%	-66.5%	
Adjusted non-GAAP Net Income	\$13.4	\$20.2	51.5%	151.6%	132.7%	
Weighted average number of shares-basic and diluted	39.2	39.6	1.0%	-42.5%	0.3%	
Adjusted Diluted EPS	\$0.34	\$0.51	50.0%	337.7%	132.1%	\$0.35 Consensus
Margin Analysis						
Gross Margin	30.8%	32.2%	4.5%	5.4%	8.9%	
SG&A	19.9%	18.8%	-5.6%	-7.9%	-16.2%	
Operating Income	10.9%	13.4%	22.9%	32.5%	87.8%	
Tax	18.0%	10.2%	-43.1%	-38.6%	-	
Net Income	7.2%	10.9%	51.7%	203.3%	-	
Adjusted non-GAAP Net Income	7.7%	10.8%	40.1%	117.7%	128.0%	

Source: Company reports, Cantor Fitzgerald estimates, and FactSet

Other key updates:

- Outlook for the animal health industry is strong based on our read of the USDA agriculture reports:** USDA is expecting record corn production in 2014/2015 at 14,407 million bushels. Dairy herds are expected to expand, although USDA has not raised its 2015 herd forecast in October (from September estimates), which is 9.335 million head for 2015. USDA raised broiler meat production forecast for 2015, which is now 2.9% above 2014 forecasts. There may be initial signs of slowing of the PEDv epidemic in hogs as farms tighten biosecurity measures and following the introduction of two conditionally licensed PEDv vaccines. USDA is forecasting 2015 pork production to be 5% higher than in 2014. The strong corn crop may be allowing for higher dressed weights in cattle, and increases in cow numbers are anticipated.
- Industry competitors are also doing well, and the rising tide is expected to lift all boats:** Merck reported strong 3Q:14 animal health revenues, with 11% year-over-year growth and highlighted that the growth was driven by its companion animal and poultry businesses. We continue to like Phibro's focus on the poultry industry as we see it being a driver of growth for many other companies. Elanco Animal Health (Eli Lilly's subsidiary) posted revenue growth of 10% and Sanofi's animal health division reported 12% growth, while Bayer's animal division only rose by 4%. Animal health-focused companies reported strong growth in 3Q:14 in livestock segments including Zoetis (10% Y/Y growth, and 13% Y/Y global growth for its livestock segment), Virbac (10.5% Y/Y overall growth, 11.7% Y/Y growth for the livestock segment), and Vetoquinol (11% Y/Y overall growth). Phibro trades at a discount to industry leader, Zoetis, and while we think that some discount is warranted, we believe that the company deserves some multiple expansion for its growth opportunities. We summarize sector comparables in Exhibit 2.

Exhibit 2: Animal Health Comparables

Company	Ticker	11/13/2014*	Cap. (mil)	2015E EPS**	2015E P/E	2015E EV/ EBITDA
Zoetis, Inc	ZTS	\$42.97	\$21,536	\$1.72	25.0	16.6
Aralana Therapeutics, Inc.	PETX	\$12.36	\$420	(\$1.72)	(7.2)	(6.8)
Vetoquinol	VETO	\$45.39	\$538	\$2.97	15.3	8.3
Virbac SA	VIRP	\$214.62	\$1,809	\$10.49	20.5	10.8
Phibro Animal Health	PAHC	\$29.07	\$1,128	\$1.57	18.6	14.0
Mean		\$68.88	\$5,086	\$4.19	19.8	12.4

*Intraday pricing, * *Phibro 2015 fiscal year used as compared to calendar 2015 for remaining companies

Source: Company reports, Cantor Fitzgerald estimates, and FactSet

2015 Guidance:

Management raised 2015 guidance from net sales of \$735-755 million and adjusted diluted EPS of \$1.46-1.51 to \$739-759 million and \$1.57-1.62 due to accelerated receipt of \$4 million in licensing revenue that was previously expected in 2016. We summarize updated guidance in Exhibit 3 below. We model sales of \$753.3 million and adjusted diluted earnings of \$1.67 /share which come in above FactSet consensus estimates of \$747 million and \$1.57.

Exhibit 3: Phibro 2015 Guidance

Fiscal Year 2015 Guidance (in millions, except per share)			
Net Sales	\$739	-	\$759
Adjusted EBITDA	\$103	-	\$107
Pro forma Adjusted Diluted EPS	\$1.57	-	\$1.62

Source: Company reports and Cantor Fitzgerald estimates

Cash: Phibro reported cash and cash equivalents of \$19.7 million on the balance sheet as of September 30, 2014.

Valuation

We value Phibro using EV/EBITDA multiples, which incorporate the positive industry outlook, in our view. We apply a 15x multiple to our 2015 estimated EV/EBITDA (using EBITDA of \$112 million, above the company's \$107 million guidance) and divide this value by the company's 40 million shares to generate a \$36 price target. Industry leader, Zoetis, currently trades at approximately 16.6x its 2015 FactSet consensus EV/EBITDA, and we maintain Phibro's discount to this name while allowing for some slight multiple expansion.

We also check our assumptions using discounted cash flow analysis (DCF) applied to cash flows from FY2015-20. We utilize a 9% weighted average cost of capital (WACC), which is slightly higher than that of Zoetis, and a 3% terminal growth rate, since we expect the animal health market to continue expanding along with the broader economy. This analysis generates a \$31 price target (up from \$27 previously). The stock is already trading in this range.

If we utilize comparable transactions like the recent Lilly acquisition of the Novartis Animal Health Business for 5x sales and think about a far smaller 2x sales multiple applied to FY:2015 Phibro sales (given Phibro's lower margins and livestock focus), we arrive at a hypothetical value of \$38 per share, which supports our BUY thesis and \$36 price target.

Risks

- (1) Any additional regulatory restrictions on antibacterial use in the U.S. or amongst international importers could decrease demand for Phibro's products.
- (2) Disruptive macroeconomic events such as wars, economic downturns that lead to reduced consumer spending, weather changes leading to droughts and increased feed prices, or currency weakness, could adversely impact Phibro's business.
- (3) Animal epidemics could temporarily reduce demand for Phibro's products.
- (4) Competition from other animal health companies or generic players could pressure Phibro.
- (5) Obsolescence of any of Phibro's antibacterials due to increased bacterial resistance could be a longer-term risk to the business.
- (6) 92.5% of share voting power is expected to reside with the Bendheim family, which may obstruct future takeover attempts.

Exhibit 4: Phibro Income Statement (dollars in millions)

	2011	2012	2013	2014A	1Q:15A	2Q:15E	3Q:15E	4Q:15E	2015	2016	2017	2018	2019	2020
Revenues:														
Product sales, net	618.3	654.1	653.2	691.9	187.5	182.4	185.7	197.9	753.3	793.4	836.7	883.2	933.4	987.6
Total revenues	\$618.3	\$654.1	\$653.2	\$691.9	\$187.5	\$182.4	\$185.7	\$197.9	\$753.3	\$793.4	\$836.7	\$883.2	\$933.4	\$987.6
Operating expenses:														
Cost of product sales	471.7	490.0	474.2	484.1	127.1	126.2	128.5	136.9	518.7	542.3	567.7	594.9	624.0	655.3
SG&A	105.4	114.8	122.2	144.0	35.2	35.6	36.2	38.6	145.6	152.3	158.1	164.3	170.8	177.8
Operating income (loss)	\$41.2	\$49.3	\$56.7	\$63.8	\$25.1	\$20.6	\$21.0	\$22.4	\$89.1	\$98.8	\$110.9	\$124.1	\$138.6	\$154.6
Interest expense	30.4	31.4	31.4	32.2	3.6	3.7	3.7	3.7	14.6	13.8	12.9	12.0	12.0	12.0
Interest expense, shareholders	4.2	4.3	4.4	1.0	0.0	0.0	0.0	0.0	0.00	0.0	1.0	0.0	0.0	1.0
Interest (income)	(0.3)	(0.3)	(0.1)	(0.2)	(0.1)	0.0	0.0	0.0	(0.06)	0.0	0.0	0.0	0.0	0.0
Foreign currency (gains) losses, net	(5.8)	1.2	3.1	1.8	(1.2)	0.0	0.0	0.0	(1.20)	(1.2)	(1.2)	(1.2)	(1.2)	(1.2)
Other income (expense)	20.6	(0.4)	0.2	22.8	0.0	0.0	0.0	0.0	0.00	0.0	0.0	0.0	0.0	0.0
Income (loss) before income taxes	(7.9)	13.1	17.8	6.3	22.8	16.9	17.3	18.7	75.8	86.2	98.2	113.3	127.8	142.7
Tax Rate	-63.8%	46.8%	-39%	NM	10%	18%	18%	18%	15.7%	28.0%	28.5%	28.5%	28.5%	28.5%
Provision for income tax	5.0	6.1	(7.0)	9.4	2.3	3.0	3.1	3.4	11.9	24.1	28.0	32.3	36.4	40.7
Net income (loss)	(\$12.9)	\$7.0	\$24.9	(\$3.1)	\$20.5	\$13.9	\$14.2	\$15.3	\$63.9	\$62.0	\$70.2	\$81.0	\$91.4	\$102.1
Weighted average number of shares-basic and diluted	68.9	68.9	68.9	32.2	39.6	39.5	39.8	40.2	39.8	40.0	40.2	40.4	40.6	40.8
GAAP EPS	(\$0.19)	\$0.10	\$0.36	(\$0.10)	\$0.52	\$0.35	\$0.36	\$0.38	\$1.61	\$1.55	\$1.75	\$2.01	\$2.25	\$2.50
Adjustments to non-GAAP Income														
Income (loss) before income taxes	(7.9)	13.1	17.8	6.3	22.8	16.9	17.3	18.7	75.8	86.2	98.2	113.3	127.8	142.7
Other income (expense)	1.0	0.0	0.0	24.6	1.1	0.0	0.0	0.0	1.1	0.0	0.0	0.0	0.0	0.0
Foreign currency (gains) losses, net	(5.8)	1.2	3.1	1.8	(1.2)	0.0	0.0	0.0	(1.2)	0.0	0.0	0.0	0.0	0.0
Loss on extinguishment of debt	20.6	0.0	0.0	22.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Intangible Amortization	4.0	3.0	4.0	4.9	0.0	0.9	0.9	0.9	2.6	3.5	3.5	3.5	3.5	3.5
Stock-based compensation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Adjusted non-GAAP Income	11.9	17.3	25.0	60.4	22.7	17.8	18.2	19.6	78.3	89.7	101.7	116.8	131.3	146.2
Provision for income tax	5.0	6.1	(7.0)	8.6	2.3	3.0	3.1	3.4	11.9	24.1	28.0	32.3	36.4	40.7
Tax adjustments	(1.0)	1.0	14.0	4.8	0.1	0.0	0.0	0.0	0.1	(9.0)	(9.0)	0.0	0.0	0.0
Total Tax	4.0	7.1	7.0	12.2	2.4	3.0	3.1	3.4	12.0	15.1	19.0	32.3	36.4	40.7
Cash tax rate	33.8%	41.2%	27.9%	20.2%	10.8%	17.1%	17.1%	17.2%	15.3%	16.9%	18.7%	27.6%	27.7%	27.8%
Adjusted non-GAAP Net Income	7.9	10.2	18.0	48.2	20.2	14.8	15.1	16.2	66.3	74.5	82.7	84.5	94.9	105.6
Weighted average number of shares-basic and diluted	68.9	68.9	68.9	39.4	39.6	39.5	39.8	40.2	39.8	40.0	40.2	40.4	40.6	40.8
Adjusted Diluted EPS	\$0.11	\$0.15	\$0.26	\$1.22	\$0.51	\$0.37	\$0.38	\$0.40	\$1.67	\$1.86	\$2.06	\$2.09	\$2.34	\$2.59
Consensus Revenues					181	185	194	747	793	836	883	934	988	
Consensus EPS					\$0.35	\$0.37	\$0.38	\$1.57	\$1.73	\$1.89	\$1.96	\$2.21	\$2.50	
Margin Analysis	2011	2012	2013	2014A	1Q:15A	2Q:15E	3Q:15E	4Q:15E	2015	2016	2017	2018	2019	2020
Gross Margin	23.7%	25.1%	27.4%	30.0%	32.2%	30.8%	30.8%	30.8%	31.1%	31.6%	32.1%	32.6%	33.1%	33.6%
COGS	76.3%	74.9%	72.6%	70.0%	67.8%	69.2%	69.2%	69.2%	68.9%	68.4%	67.9%	67.4%	66.9%	66.4%
SG&A	17.1%	17.6%	18.7%	20.8%	18.8%	19.5%	19.5%	19.5%	19.5%	19.2%	18.9%	18.6%	18.3%	18.0%
Operating Margin	6.7%	7.5%	8.7%	9.2%	13.4%	11.3%	11.3%	11.3%	11.8%	12.4%	13.2%	14.0%	14.8%	15.6%
Adjusted Net Income Margin	1.3%	1.6%	2.8%	7.0%	10.8%	8.1%	8.1%	8.2%	8.8%	9.4%	9.9%	9.6%	10.2%	10.7%
Growth (Y/Y)	2011	2012	2013	2014A	1Q:15A	2Q:15E	3Q:15E	4Q:15E	2015	2016	2017	2018	2019	2020
Net Sales		5.8%	-0.1%	5.9%	15.6%	5.6%	7.2%	7.7%	8.9%	5.3%	5.4%	5.6%	5.7%	5.8%
COGS		3.9%	-3.2%	2.1%	12.8%	3.8%	6.7%	5.8%	7.1%	4.6%	4.7%	4.8%	4.9%	5.0%
Gross Profit		11.9%	9.2%	9.6%	5.4%	9.8%	8.2%	12.2%	3.7%	1.6%	1.6%	1.6%	1.5%	1.5%
SG&A		8.9%	6.5%	17.8%	6.4%	4.2%	1.9%	-6.4%	1.1%	4.7%	3.8%	3.9%	4.0%	4.1%
EBIT		19.6%	15.0%	12.5%	53.1%	21.1%	21.1%	70.7%	39.6%	10.9%	12.2%	11.9%	11.7%	11.5%
Adjusted Net Income		28.5%	77.0%	167.7%	151.6%	227.6%	6.9%	86.2%	37.7%	12.4%	10.9%	2.2%	12.3%	11.3%
Adjusted Diluted EPS		28.5%	77.0%	368.2%	337.7%	471.6%	5.8%	82.9%	36.4%	11.9%	10.4%	1.7%	11.7%	10.7%

Source: Company reports, Cantor Fitzgerald estimates, and FactSet Consensus

Exhibit 5: Phibro Sales Estimates (dollars in millions)

	2011	2012	2013A	2014A	1Q:15A	2Q:15E	3Q:15E	4Q:15E	2015E	2016E	2017E	2018E	2019E	2020E
MFAs and other	\$273.3	\$290.5	\$303.7	\$326.6	\$80.8	\$85.7	\$87.1	\$93.3	\$346.8	\$367.6	\$389.7	\$413.1	\$437.9	\$464.1
<i>Growth</i>		6.3%	4.5%	7.5%	3.6%	7.0%	7.0%	7.0%	6.2%	6.0%	6.0%	6.0%	6.0%	6.0%
Nutritional Specialties	\$43.1	\$47.7	\$52.3	\$63.0	\$19.5	\$19.1	\$18.8	\$18.9	\$76.2	\$87.7	\$98.2	\$106.1	\$114.5	\$123.7
<i>Growth</i>		10.7%	9.8%	20.4%	38.1%	16.0%	16.0%	16.0%	21.0%	15.0%	12.0%	8.0%	8.0%	8.0%
Vaccines	\$28.8	\$36.9	\$28.9	\$41.4	\$16.9	\$12.5	\$14.0	\$15.6	\$59.1	\$65.4	\$74.5	\$88.2	\$103.5	\$120.6
<i>Growth</i>		28.1%	-21.9%	43.4%	86.5%	8.8%	36.8%	47.6%	42.7%	10.7%	13.9%	18.5%	17.4%	16.5%
ANIMAL HEALTH	\$345.2	\$375.2	\$384.9	\$431.0	\$117.2	\$117.2	\$119.9	\$127.9	\$482.1	\$520.7	\$562.4	\$607.4	\$656.0	\$708.4
<i>Growth</i>		8.7%	2.6%	12.0%	15.9%	8.6%	11.2%	12.1%	11.9%	8.0%	8.0%	8.0%	8.0%	8.0%
Mineral Nutrition	\$209.3	\$210.1	\$203.2	\$201.6	\$55.4	\$51.1	\$50.4	\$55.4	\$212.4	\$214.6	\$216.7	\$218.9	\$221.1	\$223.3
<i>Growth</i>		0.4%	-3.3%	-0.8%	20.1%	1.0%	1.0%	1.0%	5.4%	1.0%	1.0%	1.0%	1.0%	1.0%
Performance Products	\$63.9	\$68.8	\$65.0	\$59.3	\$14.8	\$14.0	\$15.4	\$14.6	\$58.7	\$58.2	\$57.6	\$57.0	\$56.4	\$55.9
<i>Growth</i>		7.8%	-5.5%	-8.9%	-0.6%	-1.0%	-1.0%	-1.0%	-0.9%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%
TOTAL	\$618.3	\$654.1	\$653.2	\$691.9	\$187.5	\$182.4	\$185.7	\$197.9	\$753.3	\$793.4	\$836.7	\$883.2	\$933.4	\$987.6
<i>Growth</i>		5.8%	-0.1%	5.9%	15.6%	5.6%	7.2%	7.7%	8.9%	5.3%	5.4%	5.6%	5.7%	5.8%

Source: Company reports and Cantor Fitzgerald Estimates

Company Description

Phibro Animal Health Corporation is an international livestock focused animal health company that manufactures animal medicines and nutritional products utilized by large industrial meat producers. At this time, Phibro's products primarily focus on the poultry and swine segments of the livestock market but the company is also making inroads into peripheral areas such as dairy and aquaculture which could become more prominent in the future.

Companies Mentioned:

Aratana Therapeutics, Inc. (PETX - NASDAQ): NC
Bayer AG (BAYN.DE - XETRA): NC
Eli Lilly and Company (LLY - NYSE): NC
Merck & Co., Inc. (MRK - NYSE): NC
Novartis AG (NVS - NYSE): NC
Sanofi (SNY - NYSE): NC
Vetoquinol (VETO - NXT PA): NC
Virbac SA (VIRP - PSE): NC
Zoetis Inc. (ZTS - NYSE): NC

Disclosures Appendix

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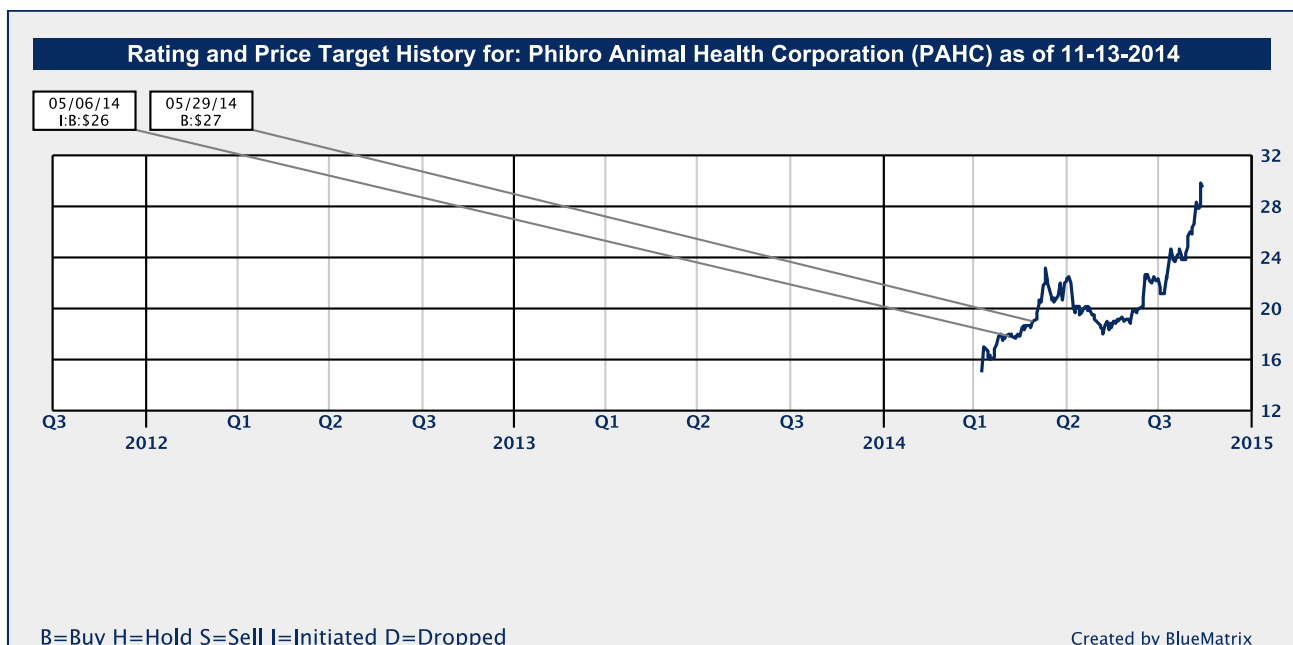
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Distribution of Ratings/Investment Banking Services (IB) as of 11/14/14

Rating	Cantor		IB Serv./Past 12 Mos.	
	Count	Percent	Count	Percent
BUY [B]	89	60.54	21	23.60
HOLD [H]	49	33.33	10	20.41
SELL [S]	9	6.12	1	11.11