Management CV

Research Note:
Phibro Animal Health (PAHC)
December 17, 2014

PAHC: CEO Has Too Much Control

Phibro Animal Health Corp.'s Chairman, President & CEO Jack Bendheim (67) returned to the CEO role in March, prior to the IPO the following month. We think Bendheim exemplifies a dominant executive, especially since he controls 92.5% of the voting power through his family's investment vehicle, BFI. We are also concerned that the CEO change occurred without explanation. The former CEO, Gerald Carlson (71), was demoted to COO. We also note the sudden departure of Director Ken Hanau (49), who resigned on October 5th, effective 3 days later. This was after the Annual Meeting had taken place. Hanau represented Mayflower Limited Partnership, which is managed by investment firm 3i Investments, Plc. There was no explanation given, although the Board stated it was not due to a disagreement. His term was scheduled to expire in 2016. We think the other Officers and Directors, besides CEO Bendheim, have weak skin-in-the-game and we'd like to see equity included as a regular component of the pay plan. Recent results have been average, in our view, with 6% sales growth last year and a 12% increase in EBIT, though we'd like to see more top and bottom line growth from a company that classifies itself as an emerging growth company under the JOBS Act. We also note that PAHC has significant leverage that may hamper management's financial flexibility.

EXECUTIVE TEAM SKILLS FIT We are cautious on the management team due to a dominant, triple titled CEO and what we view as significant nepotism. CEO Bendheim has been involved with PAHC since 1969, and worked as CEO from 1998 to 2002. He returned to that role in March. We think he has done a good job of growing the firm during his overall tenure, but also worry that he has done so at the expense of profitability and with high leverage. He also serves as Chairman of the Animal Health Institute, an industry organization that advises on animal health issues. COO Gerald Carlson, who is also a Director, served as CEO since 2002, before being demoted earlier this year prior to the IPO. He has good industry experience through his more than decade at the Company, but we think his initial hire was a poor skills fit. He came from Ecolab and held several management positions there, before leaving as the firm's SVP, Corporate Planning and Development. We are also concerned with his demotion and the likely difficulty he will have in adjusting to a lesser role. CFO Richard Johnson (65) has good experience and has been with the Company and in his current role since 2002. He worked in finance roles prior to joining PAHC, and is a familiar face to COO Carlson as the 2 worked together at Ecolab. We note, negatively, that expenses have been outpacing revenue growth lately. Last year, revenue rose about 6% and SG&A increased 18%. We think this is indicative of weak cost discipline on the part of CFO Johnson and would be concerned if this trend continued. EVP, Corporate Strategy Daniel Bendheim (42), who is also a Director, is CEO Bendheim's son. He joined in 1997 and has worked in many areas of the Company. He served as VP, Business Development in 2001, President, Performance Products in 2004, and was promoted to his current position this March. His background is in finance, as he previously worked as an Analyst at investment bank South Coast Capital. We think there may be a duplication of efforts since COO Carlson's background in Corporate Strategy and BD was cited by the firm as an area of his expertise. President, Animal Health, Larry Miller (50) has good company and industry experience, in our view. He joined PAHC in his current role in May 2008. Prior to that, he was VP of the Global Ruminant Business with Intervet/Schering-Plough Animal Health, the world's largest animal health ruminant business at the time. He was also GM for Schering-Plough's Australia and New Zealand Animal Health business. His business unit, PAHC's largest, has done well recently. In fiscal 2014, sales rose 12% and adjusted EBITDA increased 21%.

COMPENSATION & ALIGNMENT ANALYSIS We think the Board's compensation plan is poorly aligned with shareholders. The Board only discloses pay data for 3 officers. We note that in FY14 CEO Bendheim received nearly 65% of the team's total pay, which we view negatively. The 3 executives also received over 87% of their pay in cash (salary and bonus). Although options have been used in the past, there is no formal long term incentive plan.

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We would like to see equity included as a regular component of executives' compensation in order to align their interests with shareholders. Last year, there were no equity grants to the senior team. Cash bonuses are targeted at a reasonable 50% of salary. We'd like to see greater transparency in the bonus plan as the goals/metrics are not disclosed. Compensation is not based on peer benchmarking and the Board does not use a compensation consultant. CEO Bendheim received over $3.4 million in pay, including: $1.9 million in salary, a $1.1 million cash bonus, and $435k in pension and other pay. We view the latter as significant, and it is comprised of life insurance and financial/tax services to him and certain members of his family. COO Carlson received nearly $1.1 million, with $578k in salary, $337k cash bonus, $23k in equity (amount recognized from prior years) and $137k in other pay. President, Animal Health Miller's $802k pay consisted of $434k in salary, $275 in cash bonus, $23k in equity and $70k in other pay.

EQUITY OWNERSHIP ANALYSIS The Bendheim family is the dominant shareholder through a dual class structure, which we view negatively. They control 92.5% of the voting power through ownership of all of the outstanding supervoting Class B shares (10 votes per share) by their investment vehicle, BFI. 3i Investments Plc, which is the manager of Mayflower Limited Partnership, has beneficial ownership of nearly 2 million shares, or about 11.4% of the Class A shares, after selling 6.3 million shares as part of the IPO. The Bendheim's controlling stake leaves little voting power in the hands of the rest of the team, though their beneficial ownership of the Class A shares is reasonable. Directors Carol Wren (53) and Thomas Corcoran (67) bought 1k and 5k Class A shares in April after the IPO, and the rest of the ownership stake is from vested options. COO Carlson and division President Miller have 309k and 552k vested options, respectively. Both executives' options have a strike price of $11.83, which is about 150% in-the-money. We note, however, that Miller's options were granted in 2009, while Carlson's were granted in 2013. The bulk of Carlson's options (about 232k) vested immediately with the remaining amount a year later. Half of Miller's options vested after 3 years with the remaining equally over the next 2 years. We note, curiously, that the strike price for both executives' options is the same, despite being granted 4 years apart. There are no details on other grants, but it appears all options have the same strike price.

CAPITAL ALLOCATION PRACTICES We think that management has been shareholder friendly in its capital allocation, although we cannot judge consistency given its recent IPO. CapEx has been about $20 million for the last 2 years, and is forecasted at $25 million this year. The spending will be primarily directed to the Animal Health segment, including investments for the expansion of production capacity and cost reductions. PAHC has $20 million in cash and about $290 million in debt. Net debt is equivalent to 3.2x trailing adjusted EBITDA, which we view cautiously. The Board intends to pay $15 million a year in dividends, and is on pace to pay out $15.6 million. It pays the same quarterly dividend of $0.10/share on both the Class A (1.3% yield) and B shares. Management has sought to do bolt-on M&A, but only completed a small $900k deal in January. CEO Bendheim continues to search for acquisition targets, and said industry growth and an improved economy could create more opportunities. On the negative side, management seems intent on retaining the Performance Products segment, despite admitting most of its efforts are focused elsewhere. Revenue for the segment has been falling for the last several years and represents only 8.5% of the total. We are concerned that it will continue to be a drag on the overall business.

OTHER FIDUCIARY ISSUES CEO Bendheim sits on the Compensation Committee. Directors also do not have to be independent since PAHC is a "controlled company". It is also an emerging growth company, and does not have to comply with certain reporting requirements due to the JOBS Act. In addition to his son Daniel being employed by PAHC, other relatives of CEO Bendheim provided services to the Company as employees or consultants, including: Jonathan Bendheim, VP, MACIE Region and GM, Phibro Israel; Etan Bendheim, Director of Strategy, Phibro Aquaculture; Dr. Zev Jacobson, Human Pharma Liaison; and Marvin Sussman, Consultant. Bendheim's relatives received total compensation of $1.8 million in FY14. *End*