

Equity Research

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Phibro Animal Health Corporation (PAHC-\$18.54)

Rating: BUY

Target Price: \$27.00

Strong Sales and Additional Growth Expected; Maintain BUY, Raise PT to \$27 from \$26

<u>REV</u>	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>
2013A	162.1A	164.2A	162.7A	164.2A
Prev	—	—	163.4A	163.4A
2014E	162.2A	172.7A	173.3A	175.9E
Prev	—	—	169.7E	172.1E
2015E	—	—	—	—
<u>EPS</u>	<u>1Q</u>	<u>2Q</u>	<u>3Q</u>	<u>4Q</u>
2013A	0.01A	0.15A	0.08A	0.02A
Prev	—	—	0.05A	0.05A
2014E	0.12A	0.07A	0.36A	0.21E
Prev	—	—	0.32E	0.27E
2015E	—	—	—	—
<u>FY</u>	<u>2013A</u>	<u>2014E</u>	<u>2015E</u>	
REV	653.2A	684.1E	729.8E	
Prev	—	676.7E	721.6E	
EPS	0.26A	0.90E	1.41E	
Prev	—	0.63E	1.39E	
P/E	71.3x	20.6x	13.1x	

- **Sales beat consensus in 3Q:FY14:** Phibro reported revenues of \$173.3M and adjusted diluted earnings of \$0.36 versus our revenue estimates of \$169.7M and consensus revenues of \$171.8. Net sales in the quarter grew 7% Y/Y, and adjusted EBITDA grew 16% Y/Y. Management guided to 6-8% sales growth and 15-20% adjusted EBITDA growth next quarter. We reiterate our BUY rating and raise our PT to \$27 from \$26, which is based on DCF analysis, sector M&A activity, and additional opportunities for growth.
- **3Q:FY14 growth in animal health offset slightly by declines in mineral nutrition and performance products:** Animal health largely drove the growth in Phibro's sales and adjusted EBITDA. The animal health segment of Phibro represented 62% of 3Q:FY14 sales; sales and adjusted EBITDA in this segment grew by 15% and 25% Y/Y, respectively, driven primarily by volume growth rather than price increases. The company saw continued expansion of its medicated feed additives into Asia Pacific and Latin America (accompanied by additional SG&A investment) and growth of newer product categories such as its dairy cow nutritional specialties products (Omnigen and Animate) and vaccines. Vaccine sales grew 46% Y/Y, nutritional specialties (which includes Omnigen/Animate) grew 14% Y/Y, and medicated feed additives grew 12% Y/Y. Mineral nutrition and performance products declined (4%) and (9%), respectively, due to volume reductions in low-margin products. We expect these segments to remain steady longer-term, with low single-digit growth.
- **Other color from the call:** Gross profit improved by > 200 bps Y/Y due to production efficiencies (driven by cap-ex investment). Orders of nutritional products such as dairy cow nutritionals in EU softened in the past quarter due to timing and are expected to bounce back next quarter. Management expects near-term growth from Phibro's European business as well as its vaccine segment. Poultry vaccines represent a \$1 billion market, and Phibro currently captures a small percentage, which represents yet another growth opportunity. Finally, management intends to pursue additional tuck-in acquisitions to fuel growth in a sector with recent consolidation trends.
- **Poultry remains a growth driver:** While the drought has been subsiding in the United States and generally doesn't impact Phibro's business given its limited involvement in the beef cattle market, management noted that continued high prices of beef and pork in the U.S., coupled with drought in Brazil, may have driven additional growth in poultry production (evidenced by increases in heads and weights).

Current Statistics

Market Cap (\$Mil)	\$719.2	Float Shares (Mil):	17.400
Avg. Daily Trading Volume (3 mo.):	NA		
Shares Out (Mil):	17.443		

Exhibit 1: PAHC 3Q:FY14 Variance Analysis

	3Q:14E	3Q:14A	% Variance	Y/Y Growth	Q/Q Growth	Comments
Revenues	169.7	173.3	2.1%	6.5%	0.3%	\$171.8 Consensus
COGS	118.8	120.4	1.4%	3.0%	-1.0%	
Gross Profit	50.9	52.8	3.8%	15.5%	3.3%	
SG&A	33.9	35.5	4.7%	13.5%	4.0%	
EBIT	17.0	17.3	2.1%	19.8%	1.8%	
Interest Income	-0.1	-0.1	-	NM	NM	
Interest Expense	6.5	8.8	36.2%	-1.0%	0.3%	
Other Income (Expense)	0.0	0.3	-	-79.2%	-76.4%	
Pre-tax income	10.6	8.3	-21.4%	94.6%	16.4%	
Income tax expense	3.0	1.9	-35.6%	2147.7%	-60.0%	
Net income	7.6	6.4	-15.8%	52.4%	176.7%	
Diluted shares	30.5	30.7	0.8%	-55.4%	-55.4%	
GAAP EPS	\$0.25	\$0.21	-16.5%	242.1%	521.1%	\$0.20 Consensus
Adjusted non-GAAP Income	\$12.3	\$15.2	23.9%	123.5%	75.5%	
Total Tax	\$2.5	\$1.1	-56.0%	-17.7%	-76.0%	
Adjusted non-GAAP Net Income	\$9.8	\$14.1	44.3%	158.1%	245.7%	
Weighted average number of shares-basic and diluted	30.5	39.4	29.4%	-42.8%	-42.8%	
Adjusted Diluted EPS	\$0.32	\$0.36	11.5%	351.3%	504.6%	
Margin Analysis						
Gross Margin	30.0%	30.5%	1.7%	8.4%	3.0%	
SG&A	20.0%	20.5%	2.5%	6.6%	3.7%	
Operating Income	10.0%	10.0%	0.0%	12.5%	1.5%	
Tax	28.4%	23.3%	-18.0%	1054.8%	-65.6%	
Net Income	4.5%	3.7%	-17.6%	43.1%	175.9%	
Adjusted non-GAAP Net Income	5.8%	8.1%	41.3%	142.3%	244.7%	

Source: Company reports, Cantor Fitzgerald estimates, and FactSet

Other key updates:

- **Management reaffirmed its dividend:** The company reiterated its intent to pay a quarterly dividend of \$0.10 per share and anticipates the first payment will come in September, which will mean that Phibro is distributing approximately \$15.6 million in dividends annually (~2% dividend yield).
- **Acquisitions expected to fuel growth:** Management indicated that it will continue to grow via acquisitions, but is focused on smaller, tuck-in deals rather than larger scale acquisitions. We prefer this approach to higher risk R&D strategies. Management also noted that it expects the deal flow within animal health to continue as large pharmaceutical companies with significant presence within animal health continue to pursue acquisition targets.
- **Our update from USDA Livestock, Dairy and Poultry Outlook:** Pork production continues to trend down with the spreading of the Porcine Epidemic Diarrhea (PEDv) virus. There was 2.6% year-over-year reduction in first-quarter commercial hog slaughter and second-quarter hog production is forecasted to fall more than 2% as compared to the second quarter of last year.¹ On the upside, 2015 production numbers are expected to increase as the U.S. pork industry is able to utilize the experience it gained this year in treating PDEv. The poultry market remains steady with a slight increase in broiler meat production of 1.9% seen Y/Y. While the number of broiler-type chicks hatched during April was down slightly Y/Y, the number of eggs on incubators for hatching as of May 1, 2014, was 637 million, up 2% Y/Y.² Dairy cow herd projections are improving, with herd expansion anticipated in 2015;

¹ <http://www.ers.usda.gov/publications/ldpm-livestock,-dairy,-and-poultry-outlook/ldpm-239.aspx>

² <http://usda.mannlib.cornell.edu/usda/current/ChicEggs/ChicEggs-05-23-2014.pdf>

cow numbers for 2014 are now forecast at 9.255 million heads, which only represents a slight increase from 2013. Management indicated that there has been a slow repopulation of feed lots since cattle is being sold off before it reaches the lots. Moderate feed prices have the potential to drive additional growth in this space.

2014 Guidance:

Management provided 2014 Guidance, which is summarized in Exhibit 2 below. Consensus estimates for FY:2014 are \$683 million in revenues and \$1.03 EPS. We model sales of \$684 million and earnings of \$0.90/share. For 4Q:FY14 Phibro guided to net sales of \$174-176 million (relative to \$173.9 million consensus) and adjusted diluted EPS of \$0.19-0.21, which is below the consensus estimate of \$0.29.

Exhibit 2: Phibro 2014 Guidance

Fiscal Year 2014 Guidance (in millions, except per share)			
Net Sales	\$682	-	\$685
Adjusted EBITDA	\$89	-	\$90
Pro forma Adjusted Diluted EPS	\$1.19	-	\$1.22

Source: Company reports and Cantor Fitzgerald estimates

Cash: Phibro reported cash and cash equivalents of \$10.9 million on the balance sheet as of March 31.

Valuation

We value Phibro using discounted cash flow analysis (DCF) applied to cash flows from FY2014-FY2020. 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 \$27 price target (up from \$26 previously), which supports our BUY rating.

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 FY2015 Phibro sales (given Phibro's lower margins and livestock focus), we arrive at a hypothetical value of \$37 per share, which supports our BUY thesis.

Risks

- (1) Potential exit of the 3i shareholders who own approximately 7% of outstanding shares could pressure the stock.
- (2) Any additional regulatory restrictions on antibacterial use in the U.S. or amongst international importers could decrease demand for Phibro's products.
- (3) 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.
- (4) Animal epidemics could temporarily reduce demand for Phibro's products.
- (5) Competition from other animal health companies or generic players could pressure Phibro.
- (6) Obsolescence of any of Phibro's antibacterials due to increased bacterial resistance could be a longer-term risk to the business.
- (7) 92.4% of share voting power is expected to reside with the Bendheim family, which may obstruct future takeover attempts.

Exhibit 3: Phibro Income Statement (dollars in millions)

	30-Sep				31-Dec	31-Mar	30-Jun							
	2011	2012	2013	1Q:14A	2Q:14A	3Q:14A	4Q:14E	2014E	2015	2016	2017	2018	2019	2020
Revenues:														
Product sales, net	618.3	654.1	653.2	162.2	172.7	173.3	175.9	684.1	729.8	770.4	814.1	861.0	911.6	966.0
Total revenues	\$618.3	\$654.1	\$653.2	\$162.2	\$172.7	\$173.3	\$175.9	\$684.1	\$729.8	\$770.4	\$814.1	\$861.0	\$911.6	\$966.0
Operating expenses:														
Cost of product sales	471.7	490.0	474.2	112.7	121.6	120.4	123.1	477.8	506.1	530.4	556.4	584.1	613.9	645.7
SG&A	105.4	114.8	122.2	33.1	34.1	35.5	35.2	138.0	145.0	150.8	156.9	163.3	170.2	177.4
Operating income (loss)	\$41.2	\$49.3	\$56.7	\$16.4	\$17.0	\$17.3	\$17.6	\$68.3	\$78.7	\$89.3	\$100.9	\$113.6	\$127.5	\$142.9
Interest expense	30.4	31.4	31.4	8.8	8.8	7.8	6.0	30.5	14.7	13.8	12.9	12.0	12.0	12.0
Interest expense, shareholders	4.2	4.3	4.4	0.0	0.0	1.0	0.0	1.0	0.0	0.0	1.0	0.0	0.0	1.0
Interest (income)	(0.3)	(0.3)	(0.1)	(0.0)	(0.1)	(0.1)	(0.1)	(0.3)	0.0	0.0	0.0	0.0	0.0	0.0
Foreign currency (gains) losses, net	(5.8)	1.2	3.1	0.6	1.2	0.3	0.0	2.1	0.0	0.0	0.0	0.0	0.0	0.0
Other income (expense)	20.6	(0.4)	0.2	0.0	0.0	0.0	23.7	23.7	0.0	0.0	0.0	0.0	0.0	0.0
Income (loss) before income taxes	(7.9)	13.1	17.8	7.0	7.1	8.3	(12.0)	11.3	64.1	75.5	87.0	101.6	115.5	129.9
Tax Rate	-63.8%	46.8%	-39%	17%	68%	23%	NM	NM	20.0%	30.0%	30.5%	30.5%	30.5%	30.5%
Provision for income tax	5.0	6.1	(7.0)	1.2	4.8	1.9	3.0	10.9	12.8	22.6	26.5	31.0	35.2	39.6
Net income (loss)	(\$12.9)	\$7.0	\$24.9	\$5.8	\$2.3	\$6.4	(\$15.0)	\$0.4	\$51.2	\$52.8	\$60.4	\$70.6	\$80.3	\$90.2
Weighted average number of shares-basic and diluted	68.9	68.9	68.9	68.9	68.9	30.7	37.4	51.5	38.9	39.1	39.3	39.5	39.7	39.9
GAAP EPS	(\$0.19)	\$0.10	\$0.36	\$0.08	\$0.03	\$0.21	(\$0.40)	\$0.01	\$1.32	\$1.35	\$1.54	\$1.79	\$2.02	\$2.26
Adjustments to non-GAAP Income														
Income (loss) before income taxes	(7.9)	13.1	17.8	7.0	7.1	8.3	(12.0)	11.3	64.1	75.5	87.0	101.6	115.5	129.9
Other income (expense)	1.0	0.0	0.0	0.0	0.0	5.4	0.0	5.4	0.0	0.0	0.0	0.0	0.0	0.0
Foreign currency (gains) losses, net	(5.8)	1.2	3.1	0.5	0.5	0.3	0.4	1.6	0.0	0.0	0.0	0.0	0.0	0.0
Loss on extinguishment of debt	20.6	0.0	0.0	0.0	0.0	0.0	23.7	23.7	0.0	0.0	0.0	0.0	0.0	0.0
Intangible Amortization	4.0	3.0	4.0	1.3	1.3	1.2	1.3	5.0	3.5	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	8.7	8.8	15.2	13.4	47.0	67.6	79.0	90.5	105.1	119.0	133.4
Provision for income tax	5.0	6.1	(7.0)	1.2	4.8	1.1	6.0	13.1	12.8	22.6	26.5	31.0	35.2	39.6
Tax adjustments	(1.0)	1.0	14.0	(0.5)	(0.5)	0.0	(0.5)	(1.5)	0.0	(9.0)	(9.0)	0.0	0.0	0.0
Total Tax	4.0	7.1	7.0	0.7	4.3	1.1	5.5	11.6	12.8	13.6	17.5	31.0	35.2	39.6
Cash tax rate	33.8%	41.2%	27.9%	7.7%	49.0%	7.2%	41.1%	24.7%	19.0%	17.3%	19.4%	29.5%	29.6%	29.7%
Adjusted non-GAAP Net Income	7.9	10.2	18.0	8.0	4.5	14.1	7.9	35.4	54.7	65.3	72.9	74.1	83.8	93.7
Weighted average number of shares-basic and diluted	68.9	68.9	68.9	68.9	68.9	39.4	37.4	39.4	38.9	39.1	39.3	39.5	39.7	39.9
Adjusted Diluted EPS	\$0.11	\$0.15	\$0.26	\$0.12	\$0.07	\$0.36	\$0.21	\$0.90	\$1.41	\$1.67	\$1.86	\$1.88	\$2.11	\$2.35
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Source: Company reports, Cantor Fitzgerald Estimates and FactSet Consensus

Exhibit 4: Phibro Sales Estimates (dollars in millions)

				30-Sep	31-Dec	31-Mar	30-Jun							
	2011	2012	2013A	1Q:14A	2Q:14A	3Q:14A	4Q:14E	2014E	2015E	2016E	2017E	2018E	2019E	2020E
MFAs and other	\$273.3	\$290.5	\$303.7	\$78.0	\$80.0	\$81.4	\$83.0	\$322.4	\$341.8	\$362.3	\$384.0	\$407.0	\$431.5	\$457.3
Growth		6.3%	4.5%	1.2%	5.3%	11.9%		6.1%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
Nutritional Specialties	\$43.1	\$47.7	\$52.3	\$14.1	\$16.4	\$16.2	\$21.3	\$68.0	\$76.2	\$83.8	\$91.4	\$98.7	\$106.6	\$115.1
Growth		10.7%	9.8%	23.2%	28.5%	14.1%		30.0%	12.0%	10.0%	9.0%	8.0%	8.0%	8.0%
Vaccines	\$28.8	\$36.9	\$28.9	\$9.1	\$11.5	\$10.2	\$11.0	\$41.8	\$57.5	\$67.4	\$79.2	\$93.2	\$108.8	\$126.2
Growth		28.1%	-21.9%	19.2%	111.0%	46.4%		44.8%	37.6%	17.2%	17.5%	17.7%	16.7%	15.9%
ANIMAL HEALTH	\$345.2	\$375.2	\$384.9	\$101.2	\$108.0	\$107.8	\$115.3	\$432.2	\$475.5	\$513.5	\$554.6	\$598.9	\$646.9	\$698.6
Growth		8.7%	2.6%	5.2%	14.6%	14.8%	14.5%	12.3%	10.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Mineral Nutrition	\$209.3	\$210.1	\$203.2	\$46.2	\$50.6	\$49.9	\$47.3	\$194.0	\$195.9	\$197.9	\$199.9	\$201.9	\$203.9	\$205.9
Growth		0.4%	-3.3%	-7.2%	-4.3%	-3.6%	-3.0%	-4.5%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Performance Products	\$63.9	\$68.8	\$65.0	\$14.9	\$14.1	\$15.6	\$13.3	\$57.9	\$58.5	\$59.0	\$59.6	\$60.2	\$60.8	\$61.4
Growth		7.8%	-5.5%	-8.1%	-17.0%	-8.7%	-10.0%	-11.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
TOTAL	\$618.3	\$654.1	\$653.2	\$162.2	\$172.7	\$173.3	\$175.9	\$684.1	\$729.8	\$770.4	\$814.1	\$861.0	\$911.6	\$966.0
Growth		5.8%	-0.1%	0.1%	5.2%	6.5%	7.1%	4.7%	6.7%	5.6%	5.7%	5.8%	5.9%	6.0%

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:

Eli Lilly and Company (LLY - NYSE): NC
Novartis AG (NVS - NYSE): NC
Phibro Animal Health Corporation (PAHC - NASDAQ): BUY
Zoetis Inc. (ZTS - NYSE): NC
3i Group plc (private)

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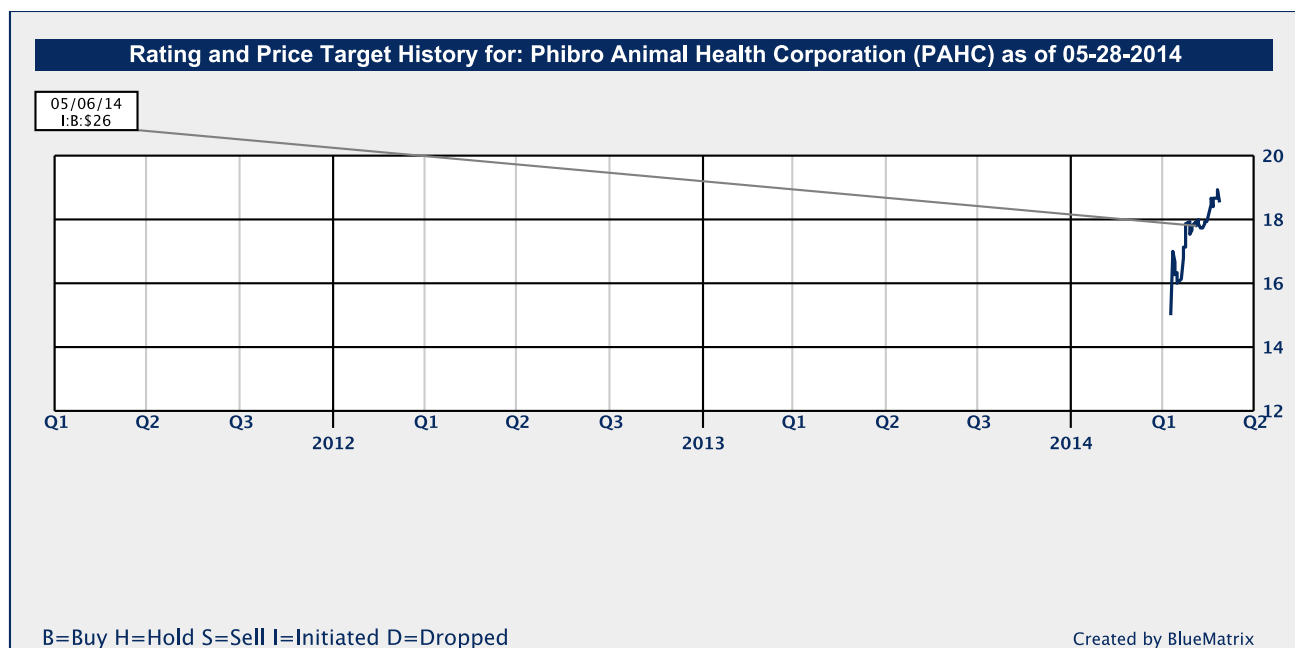
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Distribution of Ratings/Investment Banking Services (IB) as of 05/29/14

Rating	Cantor		IB Serv./Past 12 Mos.	
	Count	Percent	Count	Percent
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HOLD [H]	49	33.79	7	14.29
SELL [S]	12	8.28	1	8.33