05-Jan-2023

Neogen Corp. (NEOG)

Q2 2023 Earnings Call

CORPORATE PARTICIPANTS

Bill Waelke
Vice President-Investor Relations & Treasury, Neogen Corp.

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

Steven James Quinlan
Chief Financial Officer, Neogen Corp.

David Naemura
Chief Financial Officer, Neogen Corp.

OTHER PARTICIPANTS

Brandon Vazquez
Analyst, William Blair & Co. LLC

David Westenberg
Analyst, Piper Sandler & Co.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Neogen Corporation Second Quarter Fiscal Year 2023 Earnings Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. Please note this event is being recorded.

I'd now like to turn the conference over to Bill Waelke, Head of Investor Relations. Please go ahead.

Bill Waelke

Vice President-Investor Relations & Treasury, Neogen Corp.

Thank you for joining us this morning for the discussion of the results of the second quarter of our 2023 fiscal year. I'll briefly cover the non-GAAP and forward-looking language before passing the call over to our CEO, John Adent, who'll be followed by Steve Quinlan, our retiring CFO; and Dave Naemura, our current CFO.

Before the market opened today, we published our second quarter results, as well as a presentation with both documents available in the Investor Relations section of our website.

On our call this morning, we will refer to certain non-GAAP financial measures that we believe are useful in evaluating our performance. Reconciliations of historical non-GAAP financial measures are included in our earnings release and the presentation slide 2 of which provides a reminder that our remarks will include forward-looking statements within the meaning of the Private Securities Litigation Reform Act. These forward-looking statements are subject to risks that could cause actual results to be materially different from those expressed in, or implied by such forward-looking statements. These risks include, among others, matters that we have described in our most recent Annual Report on Form 10-K and in other filings we make with the SEC. We disclaim any obligation to update these forward-looking statements.

With that, I'll turn things over to John.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

Thanks, Bill. Good morning, everyone, and welcome to our earnings call covering the second quarter of our 2023 fiscal year. We're pleased to be with you today to provide the first view of the company's performance since the completion of the Food Safety acquisition from 3M. We delivered solid core growth in both of our segments and notably, a level of profitability well ahead of where the company was prior to the acquisition.

The former 3M Food Safety business is a great business and highly complementary and we're excited about what we've seen in the first four months of our ownership. Clearly, we've still got a number of things to do and we're early days in the integration, but we're off to a great start and we have numerous work streams fully underway across the organization to integrate our systems, products, processes and people.

Our integration philosophy has always been the best idea wins with a willingness to make any changes necessary to improve the business and ensure long-term success. We've made significant progress to date in the realignment and coordination of our commercial efforts. We combined CRM systems on day two, modified geographic coverage areas and worked together to identify and prioritize the highest potential revenue and synergy opportunities. We've had successes within the marketplace, with customers responding positively to the new products and solutions available to them.

Neogen's reputation for technical expertise and excellent customer service has been a considerable asset as we've begun to move forward as one company with one combined portfolio. Planning the relocation of manufacturing operations for our new food safety facility in Lansing and maximizing their efficiency are also key integration items receiving significant focus and attention. The manufacturing engineers from the former 3M business are assisting in the design and layout of the production process, while construction of the new facility continues on track.

In the interim, the manufacturing and distribution of the acquired products will continue under transition service agreements. And we've been collaborating with 3M to address the production and backlog issues that materialize between signing and closing of the transaction. There's still work to be done, but things are moving in the right direction and we're implementing plans that we believe will lead to further improvements as we move through the second half of the fiscal year.

While the integration activities are a broad organizational priority, we're not losing our focus on our customers. The Food Safety segment, which now comprises approximately 70% of our total revenues, grew nicely in the quarter on a core basis, including the indicator testing category, which is the most significant and profitable piece of the acquired Food Safety business from 3M.

Our Animal Safety segment had a similar level of core revenue growth led by genomics and our portfolio of biosecurity products. And tomorrow, we will be having the grand opening of our new expanded distribution center in Mt. Sterling, Kentucky, which will shorten customer lead times and allow us to ship more efficiently to our customers.

While the elevated level of macro uncertainty has led to some softening in our markets, we believe the business is resilient and well-equipped to drive future growth. We have an excellent team in place with each member working hard to ensure the new Neogen we are creating will continue its upward trajectory, gaining market share and helping our customers around the world keep the people and animals they care about safe.

Now, I'll turn it over to Steve for some more insights into our results for the quarter.

Steven James Quinlan
Chief Financial Officer, Neogen Corp.

Well, thanks, John, and welcome to everyone listening this morning. Jumping right into the results, our second quarter revenues were $230 million, an increase of 76% compared to the same quarter a year ago. Core growth, which we're introducing to replace our measurement of organic growth, excludes the impact of both foreign currency and acquisitions and was a solid 7% for the quarter. Acquisitions added a further 73%, while foreign currency amounted to a 4% headwind compared to the prior year.

At the segment level, revenues in our Food Safety segment were $161 million in the quarter, an increase of 140% compared to the prior year and included core growth of 6%. Sales of our Culture Media & Other category grew mid-single digits, driven by increases in our Neogen Analytics platform and other culture media products. Our recently acquired Petrifilm product line performed well in its first quarter under our ownership. Sales of bacteria and general sanitation products were mixed, up low-single-digits on a core basis with growth of Neogen Filters and Ampouled Media and AccuPoint general sanitation products partially offset by lower sales of rapid microbial testing products.

Rounding out our larger food safety product categories is Natural Toxins, Allergens & Drug Residues, sales of which were down slightly on a core basis. Natural toxin test kit sales were up mid-single digits on a core basis due to higher levels of aflatoxin in domestic and international grain harvests. Allergen test kits were roughly flat due to softening market conditions and supply disruptions for certain products, while drug residue test kits were down primarily due to lower sales to international dairy markets.

Quarterly revenues in the Animal Safety segment were $69 million, up 8% over last year's second quarter. Core growth was 7%, while acquisitions contributed 2%, and partially offset by 1% in negative foreign currency impact. Sales in the rodent control, insect control, and disinfectants category had a strong performance, up low-double digits on a core basis. The growth was driven by share gains in the animal protein market and sales of dairy hygiene products, as well as new insect control product introductions. Revenues in the vet instruments and disposables category were up mid-single digits on a core basis, led by strong market demand and additional sales to a large retail customer. Worldwide, core genomics revenues rose upper single digits on strong demand in US, Europe and Australian beef markets.

Gross margin in the second quarter was 48.9%, representing an increase of 250 basis points from the 46.4% in the same quarter a year ago with the increase primarily driven by the addition of higher-margin business from the 3M Food Safety transaction. Excluding the inventory revaluation charge associated with the transaction, gross margin was up over 400 basis points on a comparable basis year over year.

Adjusted EBITDA was $64 million, representing growth of 116% from the prior-year quarter, driven primarily by the merger with the former 3M Food Safety Division. Adjusted EBITDA margin was 27.8%, a year-over-year increase of 510 basis points. The increase was driven by the gross margin expansion and also by lower operating expenses as a percentage of sales. As part of the Food Safety acquisition, certain costs convey directly to us, while others did not and will need to be added over time to accommodate the larger scale of the combined business. The adjusted EBITDA margin in the second quarter is higher than what we would expect to see over the next several quarters as we ramp up these additional costs.

With respect to earnings, we reported a net loss of $42 million or $0.19 a share compared to net income of $11 million or $0.10 a share in the same period last year. The decline in earnings was primarily the result of expenses related to the 3M Food Safety transaction, professional fees, interest expense and the amortization of intangible assets. Adjusted net income, a non-GAAP measure we are introducing for comparability purposes, was $31 million for the quarter and adjusted earnings per share were $0.15 compared to $21 million and $0.19 a share, respectively, a year ago. The increase in adjusted net income was driven by higher adjusted EBITDA more than offsetting the increase in interest expense, while adjusted earnings per share were impacted by the increase in weighted average shares outstanding resulting from the Food Safety transaction.

I'll now turn things over to Dave.

David Naemura

Chief Financial Officer, Neogen Corp.

Thanks, Steve. In connection with the acquisition of the Food Safety Division, Neogen took on some debt, which we recognize as a new position for the company. However, key members of the management team have experience operating with leverage and we believe the current debt level is very reasonable, particularly when considering our targeted revenue and profitability, as well as resilient nature of our end markets.

We ended the second quarter with gross debt of $940 million and net debt of $664 million for a net leverage ratio of 3 times the last 12 months pro forma adjusted EBITDA. You'll note the gross debt amount is lower than at the closing of the Food Safety transaction and reflects $60 million of term loan repayment in the quarter. Following the close of the quarter, we repaid an additional $40 million in December. During the second quarter, we also converted a portion of our floating rate term loan to fixed via an interest rate swap and therefore we currently have a 65:35 fixed to floating ratio for at least the next 12 months, which we believe is a prudent course of action in the current interest rate environment.

You'll recall that in November we updated our outlook for achieving $1 billion in revenue and $300 million of adjusted EBITDA shifting the timing to fiscal 2025 due to changes in the macro environment and exchange rates, as well as the performance of the acquired business during the first eight months of calendar 2022. The lower-than-expected business performance is related to some supply and productivity issues that we expect to be temporary in nature. And in fact, we did see signs of improvement in the second quarter. We remain firmly committed to this outlook that we previously shared.

As we look forward to the second half of fiscal year 2023, we anticipate continued core growth in the mid-single-digit range, which includes some level of macro softening. This would result in full year core growth on a pro forma basis, also in the mid-single-digit range. As Steve noted earlier, the Q2 adjusted EBITDA margin of approximately 28% was higher than we anticipated running in coming quarters as we continue to add cost in support of the larger combined organization. Our expectation is for a full year adjusted EBITDA margin in the mid-20s range. Additionally, as we think about adjusted net income, we anticipate a full year effective tax rate of around 20% and interest expense for the full year of approximately $57 million.

Under our new capital structure, deleveraging will continue to be a capital allocation priority moving forward. We will allocate capital to building our new manufacturing site in Lansing and other organic growth drivers but deleveraging will be a priority for us. As appropriate, we will continue to execute bolt-on M&A that accelerates our growth strategy and provides for attractive returns.

I'll now hand the call back to John for some closing thoughts.

John E. Adent

President, Chief Executive Officer & Director, Neogen Corp.

Thanks, Dave. Like Steve and Dave said earlier, there's a lot of things to be excited about as we move forward. We completed the transformational acquisition of a high-quality asset, firmly positioning Neogen as a pure-play leader in food safety. This is an attractive growing end market with what we believe are long-term secular tailwinds, including heightened pathogen awareness, the increasing prevalence of food allergies and increasingly health conscious consumers who want to know what's in their food. Neogen is a resilient business, having grown now in 122 of the last 128 quarters, due largely to the consumable nature of our products which play critical roles throughout the food supply chain.

After the acquisition of the Food Safety Division of 3M, approximately 95% of our total revenues come from consumable products, which we believe positions us to continue to grow despite the current level of macro uncertainty. The feedback we've consistently heard is that the former 3M Food Safety Division has a great portfolio of products. It is the industry standard in indicator testing. We believe the focus we brought to the business, compared to their previous situation as a very small piece in a very large organization, has been energizing.

Our new team members are eager to demonstrate their capabilities and strength of their products, which we are able to combine with our leading product portfolio to offer even greater value to our customers. I appreciate their efforts and commitment and I couldn't be happier to have them on board and working with us to build One NEOGEN.

Now, I'll turn things over to the operator to begin the Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. We'll now begin the question-and-answer session. [Operator Instructions] Our first question comes from Brandon Vazquez from William Blair. Please go ahead.

Brandon Vazquez Q
Analyst, William Blair & Co. LLC

Hi, guys. Good morning and thanks for taking the question. I wanted to start first on the second half guidance for fiscal 2023. Can you talk a little bit more about what the investments you need to [ph] make or as you (00:15:50) kind of scale more, and then the follow-up question to that would basically be, as you make these investments, which makes sense as you scale, when do you expect to see more ROI off of it?

John E. Adent A
President, Chief Executive Officer & Director, Neogen Corp.

Hey, Brandon.

Brandon Vazquez Q
Analyst, William Blair & Co. LLC

Yeah.

John E. Adent A
President, Chief Executive Officer & Director, Neogen Corp.

Brandon, you cut out right in the middle of your question. Can you ask again, please?

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Yes. So, the question was around second half guidance. Just talking a little bit more about the investments that you guys said you were going to make, why the stepdown in EBITDA margins, just a little bit in the back half of the year...

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

A

Yeah.

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

...and then, basically, the timing for when you'll see ROI on those investments and when you can start to see margins expand again?

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

A

Yeah. So, what you're seeing there, Brandon, is us ramping up the business to be able to bring over the 3M and move off of the TSA and TDSA, which is the service and distribution agreements. So, as you remember, with this merger, we didn't get any back-office staff. So, we have to ramp up the IT, the accounting, logistics teams and kind of the back-office, HR and others. So, that's where you're seeing that ramp-up because those agreements were 12 months with 6 months extensions. So, you don't add all that head count immediately when you close. It takes us a little time to build those teams.

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Okay. And then, I guess the follow-up question to that is, are those investments that may take 6 to 12 months to start to see in ROI, or are they upfront costs, and then right away you can start to see some benefits?

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

A

You'll see an offset, because what'll happen is it's really an offset of cost because as we roll off those agreements, we no longer have to pay 3M for doing those service functions. So, what you're seeing more...

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Got it.

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

A

...is the roll-off of expense.

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Okay. And then, one more on kind of the profitability side, just switching to gross margin though, even when backing out the inventory step-up, it came in a little bit below our expectations just given the proxy filings of 3M's gross margin. So, kind of curious if you guys could walk through what kind of margins you're seeing or gross margins on both the Neogen side and the 3M side just to give a little bit more color on the progression of gross margins from here?

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.
A

Yeah. I think I'm really pleased with what we saw on the gross margin side coming out of the legacy business. You saw early on some margin deterioration even between sign and close with the historical 3M business and that was really around raw materials moving in that business, not pricing to match the raw materials. I think we've had this discussion before, right, about Neogen did a 6% price increase, 3M business did a 2% price increase during the same period in 2022. We implemented price increases January 1. So, we think we have an ability now that we run that business to really manage that closer to what we do than what historically was done.

Brandon Vazquez
Analyst, William Blair & Co. LLC
Q

Okay. And then, last one from me and I'll hop back in queue. Just around Petrifilm, it sounded like from a high level the updates were positive. I'm hoping you give a little more color, you guys, in terms of supply, are you kind of unconstrained at this point? It sounds like maybe not. What's the timeline to kind of get to a point where you guys feel comfortable and you're not supply constrained there anymore? Thanks.

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.
A

Yeah. You're right. We're not unconstrained. We did see the business backorders go down in the quarter. We're continuing to work with 3M to drive performance to eliminate the backorder issue. And we're hopeful that in the second half of the year we can get that fixed.

Operator: Our next question comes from David Westenberg from Piper Sandler. Please go ahead.

David Westenberg
Analyst, Piper Sandler & Co.
Q

Hi. Thank you for taking the question. And congrats on the first quarter [ph] done (00:20:00) of the full acquisition. So, you gave a lot of – you gave guidance, and maybe I'm being a little bit picky here because I am pleased to get the guidance, but there's a lot of moving parts in terms of like what core revenue is versus solid revenue. And I think you gave this mid-single-digit guidance for the back half of year. Can you give me some kind of a guide rail in terms of what that is for revenue, like an actual solid revenue number? Because I mean, I'm a little confused on whether I should do mid-single digits on core and then I just kind of don't know what to do with 3M. Yeah, so is there any kind of framework on what that means?

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.
A

Yeah.

David Naemura
Chief Financial Officer, Neogen Corp.
A

Yeah. Hey, Dave. It's Dave. So, a mid-single-digit core in the second half, if we look at today's currency rates, would imply some currency offsetting that's still at a step-down level. Acquisitions other than 3M don't have that major of an impact. Going forward, it gets a lot lower. So, we think on a reported basis, we would see growth in kind of a low-single-digit type range, which – and that's on a pro forma basis. So, I think what you'll see is second half average around, if not a little lower than what we saw in the second here with underlying quarter growth in that mid-single-digit range.

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

A

Yeah. And let me talk about, the markets are a little bit tougher than last year and we're seeing some softening, but some of the stuff that I really like about being in these markets are a couple of things that just recently happened. One was that allergen is now list – or sesame is now listed as a major food allergen. And so that's the first time the US has added a major allergen since 2004, we have 8; EU has 14. So, we continue to see and we saw a nice bump in our sesame allergen kits because of this, because now you have to test. I think long term, you're going to continue to see that grow.

Secondarily, we talked about in my release about pathogens. Last year, over 1.3 million Americans had salmonella and I was one of them. And trust me, you do not want it. It is a great way to lose weight, but you do not want it. And what happened in August was the USDA declared that salmonella was going to be an adulterant in frozen breaded chicken products. But that's just the start, right, because we're going to start with frozen breaded chicken and then we're going to move to other chicken products. And again, that's going to continue to drive testing for Neogen. So, this is why we're in such relevant markets. And even though the overall general economy is softening, things like this happen to help us continue to drive growth throughout the year.

David Westenberg
Analyst, Piper Sandler & Co.

Q

Got it. Okay. And going on the continuation of understanding that growth rate, I mean, I think you put core revenue as being 7% – and correct me if I'm wrong on core – so that's without 3M. And then Food Safety did do 8.4%. Does that imply the legacy Neogen Food Safety business was about 5% to 6%. Is my math here all right?

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

A

I think we had – go ahead, Steve. I think you can...

Steven James Quinlan
Chief Financial Officer, Neogen Corp.

A

Yeah, Dave, I think maybe you had that a little backwards. Animal was at 7% core. I believe it was 8.5%...

David Westenberg
Analyst, Piper Sandler & Co.

Q

Okay.

Steven James Quinlan
Chief Financial Officer, Neogen Corp.

A

...maybe reported. And then, Food...

David Westenberg
Analyst, Piper Sandler & Co.

Q

Okay.

Steven James Quinlan
Chief Financial Officer, Neogen Corp.

A

...was closer to 6% core. So, those are kind of the numbers for the quarter.

David Westenberg
Analyst, Piper Sandler & Co.

Q

Perfect. Okay. No, no, thank you very much. Okay. And then, this is a little bit a continuation of Brandon's question on the gross margin. I think over the longer term, I think our out-year guidance has a little bit more in the mid – or approaching the mid-50s. So, this was a little bit of down versus where expectations were. There was a mix thing. So, I think...

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

A

Yeah.

David Westenberg
Analyst, Piper Sandler & Co.

Q

...Animal Safety, generally speaking, has a lower gross margin than Food Safety. So, I mean, some of this could be mix. Is there anything else you want to call out other than just that mix?

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

A

Well, and I think not only mix between those units, but also, as now the Food Safety is 70% of the business, you've got to be aware of the mix within the Food Safety business. And again, we're not through the headwinds on the Petrifilm, but we've got still backorders to where that's one of our highest profitability lines and we have more demand than what we can sell today. So, when we get that fixed, that's really going to help. And that's the one thing that I hope you guys are taking away, too, is like even just after the first quarter, we bought a great business. I mean, it is a great margin profile, it's a highly profitable business. The new Neogen, the One Neogen is now much more profitable than we were pre-acquisition.

David Westenberg
Analyst, Piper Sandler & Co.

Q

Got it. No, that's super-helpful. So, we'll get the benefits as indicator test – the indicator is going to actually come to market.

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

A

Yeah.

David Westenberg
Analyst, Piper Sandler & Co.

Q

Got it. No, that's incredibly helpful. I'll just ask one more and I guess I'll get the rest offline a little bit later. Can you talk about the H2 EBITDA assumption? It sounds like maybe you got a little bit of a pull-forward benefit in terms of timing. I mean is that kind of the case as that – you did have some cost avoidance in this quarter that will come into H2?

David Naemura
Chief Financial Officer, Neogen Corp.

A

Yeah, look, I think that's a fair way to think about it. We're on a ramp here, so we'll see that come up. That's why we wanted to say that we came in probably a little hot at the adjusted EBITDA margin line item here in the quarter just completed, and we'll see those costs come in and will normalize back down in kind of the mid-20s.

David Westenberg
Analyst, Piper Sandler & Co.

Q

Got it. All really helpful. I'll let – maybe Brandon has some follow-ups and I'll ask the rest of those offline. Thank you so much.

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

A

Thanks, Dave.

David Naemura
Chief Financial Officer, Neogen Corp.

A

Thanks, Dave.

Operator: There are no more questions in the queue. This concludes our question-and-answer session. I'd like to turn the conference back over to John Adent for any closing remarks.

John E. Adent
President, Chief Executive Officer & Director, Neogen Corp.

Great. Thank you.

And I want to thank all of you for joining us this morning. And I hope that you had a happy and safe holidays and that your 2023 is off to a great start. We're really excited here at Neogen about what the New Year brings with our new One Neogen business and really helping our customers perform in 2023.

So, thank you again for joining us and we look forward to talking to you again on our third quarter call in the spring.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.