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Neogen Corp. (NEOG)

Q2 2024 Earnings Call

CORPORATE PARTICIPANTS

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Brandon Vazquez
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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the Neogen Corporation Second Quarter 2024 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Bill Waelke, Head of Investor Relations and Treasury. Please go ahead.

Bill Waelke

Vice President-Investor Relations & Treasury, Neogen Corp.

Thank you for joining us today for the discussion of the second quarter of our 2024 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 our CFO, Dave Naemura. 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 today, 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 2024 fiscal year. This is an exciting time at Neogen, as we're approaching several near-term milestones on the journey of integrating the former 3M Food Safety business. Following the launch of our new ERP system in September, we made further progress by initiating the exit of several transition service agreements that we have with 3M, while continuing to ramp up our internal capabilities.

On the manufacturing front, we also successfully completed the first phase of the relocation of the former 3M pathogen and sample handling product lines into Neogen facilities. The final relocation of the sample handling production we now expect to complete in Q4, but otherwise remain on track to exit all transition agreements outside of Petrifilm manufacturing by the end of the third quarter.

Moving to our results for the quarter, they were in line with the expectations we communicated on our last earnings call, with second quarter revenue and adjusted EBITDA margin modestly ahead of the first quarter. The backlog of open orders we mentioned on our last earnings call remained at the end of the second quarter, primarily affecting legacy Neogen Food Safety products and negatively impacting our core revenue growth by approximately 300 basis points to 400 basis points. We are encouraged by the orders we have in hand and are prioritizing working through the current backlog.

In our Food Safety segment, while core revenue grew modestly, it would have been up in the mid-single-digit range absent the elevated open order backlog. We experienced solid growth in Petrifilm compared to the prior year, and we saw an acceleration in Asia Pacific from the first quarter, with Japan and China showing improvement through a combination of winning back and replacing share that was lost due to historical inconsistencies in supply from our transition manufacturing partner. The strongest performance in Food Safety came in pathogen detection, where we leveraged the complementary Neogen and 3M microbiological capabilities to win new business in a core product category where we see significant growth opportunities.

In our Animal Safety segment, the distributor destocking we've been experiencing moderated in the quarter. Inventory levels in the channel remain low, but the overall destocking was at a reduced rate. Excluding Genomics where sales do not go through distribution, core growth in Animal Safety saw a nice improvement from Q1, with the rate of decline in Q2 improving by 400 basis points. In Genomics, we are seeing some incremental headwinds from the strategic shift to focus to larger, more profitable production animals, as well as companion animals.

Although the environment remains dynamic, we are encouraged by the signs of improvement we've seen in our end markets. In addition to the moderating destocking in Animal Safety, the end user demand backdrop remained stable for the first quarter. On the Food Safety side, inflation is beginning to ease, albeit slowly, and there is a general view that a continuation of this trend will lead to volume inflection for food producers in calendar 2024.

We view these as positive developments. But with the greater visibility the first half of the year now affords us, we believe these improvements are happening at a slower pace than our full year outlook had originally contemplated. Accordingly, we are updating our full year outlook to reflect the current view of these impacts, including the strategic shift underway in our Genomics business. With the largest external challenges we've been experiencing seemingly beginning to stabilize, our focus remains on the value creation opportunity we have through continued progress on the integration of the former 3M Food Safety business, while positioning ourselves to capitalize on an improved end market environment.

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

David H. Naemura

Chief Financial Officer, Neogen Corp.

Thank you, John, and welcome to everyone on the call today. Jumping into the results, our second quarter revenues were $230 million, essentially flat compared to the same quarter a year ago. Core revenue, which excludes the impact of foreign currency, acquisitions and discontinued product lines, declined just under 1% for the quarter. Acquisitions and discontinued product lines added a net 20 basis points, while foreign currency contributed 50 basis points compared to the prior year. Notably, we passed the one year anniversary of the 3M Food Safety transaction on the first day of our second quarter, and accordingly, those revenues are now included in our core growth.

Moving to the segment level, revenues in our Food Safety segment were $164 million in the quarter, an increase of 2% compared to the prior year, including core growth of 1%. The core growth was led by the Bacterial & General Sanitation product category, which benefited from the pathogen business wins John mentioned, as well as increased distributor orders in Latin America. Within the Indicator Testing, Culture Media & Other category, solid growth in Petrifilm and food quality and nutritional analysis sales was offset by a decline in culture media due mainly to a large one-time order in the prior year period. Natural Toxins & Allergens had a mid single-digit core decline, with growth in allergen test kits offset by a decline in natural toxin test kits due primarily to shipment delays.

Quarterly revenues in the Animal Safety segment were $65 million, which includes a core revenue decline of 5% compared to the prior year quarter. The destocking trend abated somewhat, with non-Genomics sales that go primarily through distribution down less than 3%, which was a notable improvement from the first quarter. Core growth in the segment was led by Life Sciences, a result of increased demand for substrates used by manufacturers of diagnostics tests, and Vet Instruments & Disposables, with higher sales of detectable needles and syringes.

Growth in these product categories was offset by continued lower sales of certain animal supplements and wound care products in the Animal Care & Other category due mainly to ongoing supply constraints. Our biosecurity products experienced a slight core revenue decline, with higher volumes in rodent control products offset by a decline in insect control products, largely the result of the phasing of certain distributor booking programs. Worldwide Genomics revenue was down mid single-digits on a core basis, which marked a deceleration from the first quarter. We continued to see decline related to small production animals, reflecting our strategic shift away from these offerings. The effects of this strategic shift in focus offset growth in international beef markets.

From a geographical perspective, core revenue growth was mixed. Growth was led by Latin America, which grew low double-digits from strong Petrifilm, pathogen and hygiene monitoring sales. Asia Pacific grew modestly, with solid growth in Genomics in Australia and China mostly offset by a slight decline in Food Safety sales. We saw a trajectory of recovery in Japan, while China, although a very small part of our total business, showed significant improvement from the first quarter.

In the US and Canada, core revenue declined in the mid single-digit range. Food Safety sales were mostly flat, with solid growth in Petrifilm and pathogens offset by the compare-driven decline in culture media, while Animal Safety sales, which include Genomics, were down mid single-digits. The US and Canada is the region most impacted by the build in backlog that we saw during the quarter. Finally, sales in our EMEA region also declined in the mid single-digit range, as strong growth in pathogens was primarily offset by the aforementioned shipment delays and certain other Food Safety product categories.

Gross margin in the second quarter was 50.9%, representing an increase of 200 basis points from 48.9% in the same quarter a year ago, with the margin expansion driven primarily by benefits from favorable product mix. Adjusted EBITDA was $55 million in the second quarter, with an adjusted EBITDA margin of 24%, representing a sequential improvement of 110 basis points from the first quarter.

On a year-over-year basis, last year's second quarter followed the closing of the 3M Food Safety transaction and adjusted EBITDA at that point did not include a full reflection of necessary expenses which were only beginning to ramp up at that time to accommodate the increased size of the company and enable the exit of various transition arrangements. Adjusted net income was $25 million for the quarter, with adjusted earnings per share of $0.11, compared to $31 million and $0.15 million respectively in the prior year period. The decline in adjusted net income was driven by lower adjusted EBITDA, which more than offset the reduced interest expense.

We ended the quarter with gross debt of $900 million, 67% of which remains at a fixed rate, and a total cash position of $230 million. Relative to the first quarter, cash was impacted by an increase in working capital, primarily reflecting the purchase of finished goods inventory from 3M as we move the acquired products into our own distribution network as part of our transition agreement exit activities.

As John mentioned earlier, with the first half now behind us, we are in a better position to update our view of the fiscal year. While we believe things are beginning to stabilize in our end markets, we do not believe they're improving as steadily as contemplated in the original guidance we provided in July. We are updating our guidance to reflect the slower pace of recovery, as well as incremental headwinds in our Genomics business and now expect full year revenues to be between $935 million and $955 million.

Taking into account the impact of the lower expected revenue, we now expect adjusted EBITDA will be in the range of $230 million to $240 million. We continue to expect capital expenditures to be approximately $130 million, including integration-related capital expenditures of approximately $100 million, the majority of which we do not expect to repeat next fiscal year.

With respect to the third quarter, we expect a modest increase in revenue from the second quarter, despite it historically being seasonally lower, and some impact from our ongoing work with transition agreement exits and the elevated backlog. We expect our adjusted EBITDA margin in the second half of the year to be higher than the first half. This would reflect sequential improvement in the third quarter and more substantially in the seasonally higher fourth quarter, driven by increased volumes and the exit of transition agreements.

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. We took significant integration steps in the second quarter, launching our new ERP system and initiating the exit of our transition services agreements, which are important parts of the journey we're on to integrate the former 3M Food Safety business. While working on the integration, we've also been navigating end market weakness, which has unusually been happening simultaneously in both Food and Animal Safety, primarily driven by the post-COVID recovery in terms of inflation and rightsizing of output. Encouragingly, the second quarter, we began to see signs that this end market weakness is abating, particularly as it relates to food production volumes and distributor inventory levels.

We believe our end markets are supported by secular tailwinds, and the progress we've been making on the integration and prioritization of key growth initiatives only strengthens our position from which to capitalize as they improve. Moreover, as we continue to move forward through the integration, it puts us closer to what we believe is an even more attractive financial profile post integration, particularly as capital spending settles into normal levels. Our team members around the world have expended tremendous effort on the integration of these high-quality businesses and continue to do so ahead of our upcoming milestones. And I want to wrap up here today by once again thanking them for their hard work and dedication.

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

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] The first question today comes from Brandon Vazquez with William Blair. Please go ahead.

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Hey. Good morning, everyone. Thanks for taking the questions. Dave, maybe I'll start with you. Maybe can you walk us through a little bit the updated guidance range, especially kind of like what's assumed at the high end of the range, what's assumed at the low end of the range, given this is a little bit of a moving target at the moment, given some of the macro backdrop. What gives you confidence in kind of the step-up in sales and profitability? And if possible, can you quantify any of the benefits that you might see on both of those ends coming in the back half of the year.

David H. Naemura
Chief Financial Officer, Neogen Corp.

A

Yeah. Thanks for the question, Brandon. I think, first of all, the second half typically is a little seasonally better than the first half. So, I think when we look at the second half, we're counting on the impact of that seasonality. The market not improving greatly. Again, we've said we had anticipated market recovery in the year. We see that happening a little slower and pushing out, but we need to see some improvement in the end market. And I think those are the two bigger levers.

And then frankly, we talked about some challenges that we've had in the second quarter and getting some stuff out the door, we see that improving during the third and as the year goes on. So, we need to see that improve as well. And I think particularly in the macro, it's been a little slower to develop. So, the pace of recovery there will impact the range. We anticipate seeing some internal improvements in shipping in the third. We're pretty happy with what we accomplished in the second, as John noted. But there was a lot going on. I think those are probably a couple of the bigger levers within the range.

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Okay. Maybe, John, for you, maybe a higher-level picture. We're a year past the deal now. A lot of great integration work has happened. I think one thing we haven't quite seen yet though is we used to talk about kind of the high-single-digits-plus, maybe even some double-digit growth periods as a combined entity. And I know there's obviously a lot of other moving factors here. There's macro and there's some integration. Harder for us to know maybe the specifics of all those details. So from your end, has your conviction on what this combined entity can do changed at all, now that we sit here a year later? And then, the second part of that maybe is for Dave.

Similarly, as we look at fiscal 2025 and where we are with fiscal 2024 guidance, are we kind of still on track for those fiscal 2025 pro forma targets?

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

A

Yeah. Thanks, Brandon. Good to talk to you. Yeah, my conviction has changed. It's gotten better. I mean, I think the things that I've seen during this first year and even the amount of things we accomplished in the second quarter really gets me excited about the future long term. And I think that's the thing is that it's sometimes hard to look through all the noise of everything that's going on to look and see what this business is going to be when we're done. And we have made so much progress.

If you think about the things we've done in the quarter with converting to SAP, predominantly moving off all of the distribution agreements and the tech service agreements, the only thing hanging out there then is Petrifilm, the plants, the building is up, [ph] that's enclosed (00:18:51), equipment's going. I mean, we're making such great progress. And I was excited by a number of things that I saw. One is, I think the market is firming up. As Dave said, it's not to where we thought it was when we got out the crystal ball nine months ago. But we are seeing that the Food Safety market is firming up.

The other thing we see is that the destocking has slowed down. The inventory levels are the same. They haven't gotten any lower. I think you do have an inflection point there. So, I'm excited about the second half. I'm excited around where the business is moving and then the resiliency. Petrifilm business had a very strong quarter. Pathogen business, the MDS had a very strong quarter, and that worked right into what we had talked about with cross-selling, right?

We're bringing that new pathogen business to existing Neogen customers and really are growing that franchise. So, excited about that. And then, the bounce-back in APAC was really strong for the quarter, which I really like. So, yeah, I'm excited about it. I'm excited to talk to people and let them know where we're going. We've got a lot of things to do. We've done a ton. We've got a lot more behind us than we do in front of us, and that gets me really excited.

David H. Naemura
Chief Financial Officer, Neogen Corp.

A

Yeah. And then, Brandon, really quickly to your point about 2025. Look, I mean, we originally came out with a view on 2025 back in December of 2021, and a lot transpired between the signing and close of the acquisition, and then frankly in the first 12 or 13 months of – I guess more now 15 months of ownership. So, although 2025 will be dependent on where we see the market when we exit, I think what's the same is what we see in the long-range potential of the combined businesses or, as John notes, we're maybe even more bullish on that.

So, we think the thesis holds. It's just the timing of kind of the market puts and takes between now and then. We want to get to – next year, get to our guidance time and we'll update people on 2025 based on what we see as an exit rate coming out of the year and the outlook for next year. Important to note that we think the thesis holds around our view of these combined businesses. It's the timing that's at play. It's difficult to call here while we're still working through 2024, and we'll give an update when we give guidance for 2025.

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Okay. Thanks, Dave. And maybe one last follow-up to that last comment you were making. Just to be clear, we're talking a lot of moving pieces, but many of these seem like they'll be executed on in fiscal 2024. Is the biggest maybe uncertainty in the bridge from today to fiscal 2025 macro or are there other factors that we should be keeping an eye on?

David H. Naemura
Chief Financial Officer, Neogen Corp.

A

So, I think macro is the biggest, pace of recovery, state of the macro economy. We're going to work through the things that are within our control, but not everything is. So, we'll snap the line on the environment as we exit the year.

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Okay. Thanks, guys.

David H. Naemura
Chief Financial Officer, Neogen Corp.

A

Thank you.

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

Q

Hi. This is [ph] John (00:22:14) on for Dave. Thanks for taking the question. Can you walk us through what the Genomics business performance would look like aside from the loss of the customer and how we should think about that going forward?

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

A

So, when you think about the Genomics business, what's really driving that is we made the decision that when you use – or when you service smaller animals like poultry that have a relatively low value and those customers are under tremendous distress in their business, that the price pressure for those services got to a point where we decided that's not interesting to us. So, we refocused the business to really move to the higher value, which is larger animals, cattle, dairy and companion animal. And that's a big point.

Quantifying what those customer losses were, I mean, I think it's in the $3 million to $4 million range, but I don't really have that. It's not a – when you think about it from the total piece of the business, it's not a – to me, it's not really material. It's really that macro environment of those – poultry predominantly and some swine, but poultry predominantly is really the challenge and really finding ways that – it just got to a price point that was unsustainable for us.

Q

Got it. Thank you. And can you remind us of any other second half comps that we should be aware of for our models?

David H. Naemura
Chief Financial Officer, Neogen Corp.

A

[ph] I don't think I'd call anything out (00:23:53) in particular at this stage.

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

A

I mean, I think the only thing, [ph] John (00:23:57), is like we talked about with the macro environment, right. Looking at the same thing we do. You know who our customer bases are and looking at their commentary around the second half. We're really aligned with them. And the things that I've seen from a number of them, they're pretty much same – same story with the customers that they are value-buying and that they are seeing the market improving, but they're still not growing. So, sequentially, they're getting better, but it's still not to a point where they have growth, and that's what we're seeing in the marketplace. So, I think that would be the thing that I would most watch is that macro environment. Dave, you got anything you want to add to that?

David H. Naemura
Chief Financial Officer, Neogen Corp.

A

I think that's right, yeah.

Q

Got it. Thank you.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to John Adent for any closing remarks.

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

Thank you, Betsy. I just want to thank everybody for joining us this morning. We're excited about the second half of the year, and I want to wish all of you a fantastic 2024. And I look forward to talking to all of you again in April.

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