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Neogen Corp. (NEOG)

Q3 2024 Earnings Call

CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and welcome to the Neogen Corporation Third Quarter 2024 Earnings Call. At this time, all lines are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session. [Operator Instructions] This call is being recorded on Tuesday, April 9, 2024.

I would now like to turn the conference over to Bill Waelke. Please go ahead.

Bill Waelke

Vice President-Investor Relations & Treasury, Neogen Corp.

Thank you for joining us this morning for the discussion of the third 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 third 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 for the third quarter of our 2024 fiscal year, which saw us complete a number of milestone achievements on our integration journey. We completed the relocation of the former 3M pathogen detection product line and on our manufacturing in one of our Lansing facilities. We also completed the first two of our four-phase relocation of the former 3M sample handling product line to one of our facilities in Lexington, with the remaining two phases expected to be completed by the end of the fiscal year and production beginning in Q1.

The manufacturing of Petrifilm will continue under the current transition agreement until we have our own Petrifilm line operational in our new facility in Lansing. The construction of the facility is almost complete. Work has begun on outfitting the interior and we have taken delivery of several initial shipments of production equipment with the more significant shipments expected to arrive in the fall.

Our plan is to exit the Petrifilm transition agreement gradually, as we first qualify and then ramp up our own production. The initial term of the Petrifilm agreement ends in August of 2026, with our goal clearly being to exit before that time. Over the past several quarters, we've scaled up our back office and distribution capabilities. And during the third quarter, completely exited the transition services and distribution agreements we have with 3M. This in combination with the related system implementation has, however, created inefficiencies in our operations that we're continuing to work through.

These inefficiencies have negatively affected the rate at which we're able to meet end user needs and ship products to customers. This has contributed to an extended period with a higher-than-usual backlog of open orders that invariably has negatively impacted demand when our products have not been readily available. In most instances, we believe these situations represent lost sales more than lost customers. But there are clearly some customers we're going to have to win back.

Moving to the results of the quarter, we had solid core revenue growth in both segments, although it was below our expectations due to the aforementioned shipping inefficiencies. We're encouraged, though, by the continued improvements we've seen in the end market environment. On the Food Safety side of the business, most food producers saw continued sequential improvement in unit production volumes, a trend that we expect to continue. Our Food Safety core revenue grew in the mid single-digit range, led by another strong quarter of Petrifilm sales, including a return to growth in Japan where we had previously experienced some customer attrition due to supply constraints.

In Animal Safety, destocking in the large veterinary distributors was no longer a headwind, with the inventory levels having normalized and some distributors having selectively begun to rebuild inventory in certain product categories based on end market demand. Our core revenue growth in this segment was also in the mid-single-digit range, led by our broad portfolio of biosecurity products and vet instruments. Excluding our genomics business, Animal Safety core revenue growth in the quarter was strong, up in the mid-teens range, albeit on an easier compare against a destocking quarter in the prior year.

In genomics, we're seeing the business stabilize, as we shift our focus toward the large animal end of the market. Although still down on a year-over-year basis, we did see core revenue trend positively for the second quarter. While the end market environment is improving, we're updating our full-year outlook to reflect the expected impact of our shipping issues.

We believe these challenges are temporary and that we will be able to recover the lost revenue. But we do expect to see a near-term impact on the lower shipments in Q3 and the rate we're carrying into Q4. It is clear they will take additional time to get the shipping levels where they need to be on a sustainable basis to serve end market demand. Resolving these challenges and meeting our customers' needs are our highest priority.

On the product development front, we continue to see benefits from our broadened R&D capabilities, particularly as it relates to our pathogen detection product offering. We recently received approval of a new molecular detection assay from AOAC, which is an independent body of analytical science professionals that validates testing methods for the food safety industry.

This new assay, which we expect to officially launch later this month, provides rapid and specific detection of two salmonella serotypes that are highly relevant for the poultry industry. We believe this assay utilizes a simpler protocol and is more user friendly than competitive options, and it allows users of the Neogen Molecular Detection System platform seamlessly run these additional serotype tests.

Pathogen detection is a significant area we are focused on to drive growth, leveraging the complementary product technologies and technical capabilities of our combined organization. We also continue to drive innovation in our food quality and nutritional analysis business. We have recently developed a testing method utilizing proprietary technology that allows bioethanol producers to determine how much of their production is from cellulose versus starch-based raw materials.

This test is the first to market of its kind and can provide significant value to these producers, as they're able to command a premium for cellulose-based bioethanol. Food quality and nutritional analysis is an attractive market and we're excited about the additional opportunities we have to capitalize on the demand for greater visibility in food content overall.

When we made the strategic decision to expand our scale and solidify our position as the global leader in food safety by acquiring the former 3M Safety Division (sic) [3M Food Safety Division], we recognize there would be a complex and challenging carve-out and integration of the business. While I am not pleased with the present inefficiencies, we are committed to navigating the challenges and ultimately realizing the long-term benefits of this combination.

I'll now turn the call over to Dave for some more insights into the 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 third quarter revenues were $229 million. Core revenue, which excludes the impact of foreign currency, acquisitions and discontinued product lines, grew over 6% for the quarter, while foreign currency was a headwind of 140 basis points compared to the prior year. As John mentioned, this growth was impacted by our shipping inefficiencies, as we did not reduce our past due backlog, as we had planned; and our extended lead times negatively impacted demand.

Moving to the segment level, revenues in our Food Safety segment were $158 million in the quarter, an increase of 4% compared to the prior year, including core growth of almost 6%. The core growth was led by the Indicator Testing, Culture Media & Other product category, which benefited from double-digit growth in our Petrifilm and sample handling product lines, primarily driven by North America and Europe.

Within the Natural Toxins & Allergens category, solid growth in allergens from tree nut test kits and improved product availability in North America was offset by a decline in natural toxins due mainly to reduced product availability. The Bacterial & General Sanitation product category saw growth in microbiology and general sanitation, partially offset by a decline in pathogens, due primarily to the shipment delays to Latin America and Asia.

Quarterly revenues in the Animal Safety segment were $71 million, which includes a core revenue increase of 7% compared to the prior year quarter. We saw the destocking trend normalize with non-genomic sales that go primarily through distribution up 15% on a core basis, a significant improvement from the second quarter.

We saw core growth in all major product categories, led by our biosecurity portfolio, a result of new business wins and increased demand related to the ongoing avian flu outbreak. Our Vet Instruments & Disposables products also experienced strong growth due mainly to higher sales of detectable needles and syringes.

Finally, in the Animal Care & Other category, similarly strong growth was led primarily by higher sales of vitamin injectables and biologics. Worldwide genomics revenue was down mid-single digits on a core basis, which marked a slight improvement from the second quarter. The decline continued to be driven by small production animals, reflecting the strategic shift away from this end of the market. The effects of this strategic shift in focus offset growth in Europe and in dairy genomics in China.

From a geographical perspective, core revenue growth was mixed. Growth was led by North America, which grew high-single digits from strong growth across most key product categories, including Petrifilm, pathogens, sample handling, hygiene monitoring, biosecurity and vet instruments. Our business in Europe grew mid-single digits on a core basis with strength in Petrifilm, pathogens and sample handling, as well as genomics.

Asia Pacific core revenue was roughly flat on a year-over-year basis, with strong growth in allergens, biosecurity products and genomics, offset by declines in pathogens and sample handling. Notably, we saw a return to growth in China and Japan, including Petrifilm, which had been challenged by some lost customers due to product availability issues.

In Latin America, core growth was also roughly flat after strong growth in the second quarter. Higher sales of allergen test kits, biosecurity products, vet instruments and genomic services were offset by lower sales of culture media, pathogens and sample handling products due in part to shipping constraints impacting our export levels.

Gross margin in the third quarter was 51.1%, representing an increase of 160 basis points from 49.5% in the same quarter a year ago, with the margin expansion driven primarily by the recovery in sales of the former 3M products, particularly Petrifilm, compared to the prior year Q3. Adjusted EBITDA was $53 million in the quarter, with an adjusted EBITDA margin of 23%, representing a year-over-year decline of 50 basis points.

The margin decline resulted from growth in operating expenses more than offsetting the gross margin improvement. During the last 12 months, we have added costs to extract ourselves from the transition service agreements and also experienced certain inefficiencies, mostly in logistics as we work through the integration of distribution activities.

Finally, we have added additional investment that contemplated the business being at a higher operating level, and we are planning to address those costs and others during Q4. Adjusted net income and adjusted earnings per share were essentially flat to the prior year quarter at $26 million and $0.12, respectively. The higher adjusted

EBITDA in the current year Q3 fell through to adjusted net income at a lower rate, primarily due to higher depreciation expense related to our ERP implementation.

We ended the quarter with gross debt of $900 million, 67% of which remains at a fixed rate and a total cash position of $168 million. Cash was impacted by planned integration CapEx and further purchases of finished goods inventory as we exited the 3M distribution network. Cash was further impacted by an elevated accounts receivable balance, driven mostly by the back-end loaded nature of the quarter as well as the semiannual interest payment on our bonds.

As John mentioned earlier, we are encouraged by the positive direction in which our end markets are trending. However, the impact from our shipping efficiency (sic) [inefficiency] impacted Q3 and will continue in Q4 at a rate higher than previously anticipated. As a result, we are updating our full-year guidance and now expect revenue to be between $910 million and $920 million and adjusted EBITDA to be in the range of $210 million to $215 million. We continue to expect full-year capital expenditures of approximately $130 million, including integration-related capital expenditures of approximately $100 million, the majority of which we do not expect to repeat next year.

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. The third quarter marked a significant step in the integration and our ultimate journey towards full autonomy as a combined business. Certain aspects of the integration, however, have taken longer than we anticipated. And while the operational inefficiencies we're currently experiencing are disappointing, we have our arms around the key issues and are fully committed to resolving them in the near future.

We expect to return to more typical growth levels, but have initiated a comprehensive review of our operating infrastructure to identify where we can better balance investments in the business with the growth that we've seen this year and the growth we expect to achieve, given our leadership position in an attractive end market. The integration process we've made has also come with substantial investment in working capital and CapEx this year, which we expect will reduce significantly in 2025.

We've spoken in the past about reviewing different parts of our portfolio and that work has accelerated. Importantly, the external market weaknesses we have been navigating for the past several quarters is improving. Unit production volumes in the food industry are still mostly negative, but are improving; and animal safety distributor inventory levels have largely come back into balance. It is our job now to address the internal challenges from the integration to capitalize on the improving end market environment and also bring back customers who may have gone elsewhere during inconsistencies of supply and we will.

Our team members around the world have worked tirelessly and continue to do so, not only on integration, but also on positioning the company to capitalize on its multiple long-term growth opportunities. I want to thank them again for their efforts and dedication.

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

QUESTION AND ANSWER SECTION

Operator: Thank you, ladies and gentlemen. We will now begin the question-and-answer session. [Operator Instructions] Your first question comes from David Westenberg with Piper Sandler. Please go ahead.

David Westenberg
Analyst, Piper Sandler & Co.

Q

Hey. Yeah. Thank you for taking the question and good morning. So, just can you talk about some of the working capital and inventory? Of course, you had the [ph] unability (17:43) to fulfill. But just as we're projecting kind of the working capital, cash flow, I think you said fulfillment won't completely get done in Q4, but can you just kind of talk about how that inventory is going to kind of like trend into Q4 and then into the first half? And I get that there's a lot of moving parts, you're not exactly giving guidance on free cash flow and kind of what that's kind of moving. But just help us understand conceptually what's going on as we model forward.

David H. Naemura
Chief Financial Officer, Neogen Corp.

A

Thanks, David. If we look at the quarter itself, this was the second quarter in a row where we brought 3M finished goods inventory into our distribution channel. So, we've brought in between Q2 – mostly in Q2 and Q3, about $48 million of inventory, which should be the size of the transfer here.

David Westenberg
Analyst, Piper Sandler & Co.

Q

Yeah.

David H. Naemura
Chief Financial Officer, Neogen Corp.

A

There were some other cash outflows in the quarter, some of them planned. Integration CapEx was about $23 million in the quarter when you think – we believe we're on track for the full-year estimate of around $100 million of integration CapEx, plus $30 million of recurring. Receivables was higher in the quarter as a result of the back-end loaded nature of the quarter as we ramped throughout the quarter.

But to your point, as we come off the order-to-cash cycle with 3M and have that fully in-house, there's some moving pieces. At the beginning of the year, we talked about full-year free cash outlook for the year at about flat, albeit a bit of an aspirational number given the desire to improve working capital on the legacy side of the business.

Improving working capital, we're seeing some of that, but we are hampered in inventory on the legacy side of the business, but more – so I would say all other things being equal, we would not be flat, we would be off maybe $25 million to $30 million full year. But two additional headwinds to that principally are higher 3M inventory.

We had thought $40 million, it's coming in now, call it, $50 million, $48 million and then, of course, lower EBITDA for the year. And we think that all results in a free cash – negative free cash full year of around $75 million, with – agreeing with your caveat that there are a lot of moving pieces as we work through the integration and the impacts on inventory of the inefficiencies in the plant.

Kind of the last part of your question looking forward, not ready to go there. We think significant, though, step-down in integration CapEx. So, we see an improvement year-over-year from that as well as the impact of better efficiencies and better linearity in the quarter all towards going to what you've heard me said before is I believe once we get through integration, 100% free cash conversion basis here.

David Westenberg
Analyst, Piper Sandler & Co.

Q

Got it. No, that's a lot of great detail, Dave. I'm sorry, John. I cut you out, didn't I?

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

A

No, no...

David Westenberg
Analyst, Piper Sandler & Co.

Q

I cut off John. Okay, John. Specifically, can you talk about what's left in integration? I know there's integrate – I think it's indicator testing in sample handling is kind of what's left. Can you kind of give us some of the dates here – further details on dates? And can you just remind us what's going through the facility?

I mean, what you're kind of in-housing to Lansing, just kind of give us an indication of what key product categories you might have to deal with some of the integration left and just to confirm and, sorry, squeezing in one more and I promise this is the last one, is every facility now on SAP and all the ERP stuff is now behind you? Sorry, I know that's a lot. Thank you.

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

A

Yeah. No, thanks, David. So, regarding the integration, we've done two phases of the four-phase step for sample handling. So, we expect sample handling to be completed. Majority will be done in the fourth quarter and be done by Q1. So, that's the one piece we have with the sample handling piece.

Again, Petrifilm, the plant is pretty much done. We've started to bring in shipments already of equipment and setup. We expect the majority of those shipments of the main equipment to be coming in during two, three quarters. Again, the indicator goes through 2026, but our plan is to move off of that as judiciously as we can. And again, it's not a hard [ph] cutover (22:38). Remember, we're doing the ramp-up, ramp-down where we have indicator testing, Petrifilm being made in two plants today on the 3M side.

And as we qualify ours and ramp up production, we'll start to draw off theirs. So, we feel like supply from that will be – we can handle that fairly well because it's not a hard cutoff like we did on some of the other ones. Pathogen testing is done. That's in our facility in Lansing. So, that's a big milestone. We're very excited about bringing that in-house and the growth we've had in those areas.

Regarding SAP, the major facilities in the US are already on SAP. We are not going to do a full rollout on some of the international locations are just too small. We have [ph] SAP LITE, so to speak, SAP One (23:30) in some of our external locations. But you remember a lot of our international businesses don't have manufacturing. They're just real sales and the distribution offices. So, that's why we're not going to roll it out across the country – or across the world. It doesn't need to do that.

David Westenberg
Analyst, Piper Sandler & Co.

Q

Got it. Thank you so much for the detail.

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

A

Yes.

Operator: Your next question comes from Brandon Vazquez with William Blair. Please go ahead.

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Good morning everyone. Thanks for taking the question. I wanted to focus a couple kind of near-term questions first. First on the inefficiencies of kind of integrating the 3M business, do they get worse quarter over quarter? I think last quarter you were talking about a $10 million headwind. I'm not sure if you guys were giving a number this quarter on what that headwind was.

But maybe just talk about sequentially, I think there was some hope last quarter that things would improve into the – through the rest of the fiscal year. Are things kind of going that way? Do you guys think you have a handle on what needs to be done and what is that and what gives you the confidence to be able to do that?

David H. Naemura
Chief Financial Officer, Neogen Corp.

A

Brandon, good morning. It's Dave. Let me add a point or two and then pass it to John. If we think of backorders or in-house orders that are unfulfilled, that was about flat from Q2 to Q3. And as you'll note, as you point out, we were hoping to make improvement there.

The impact to demand is tougher to measure. But recall that the legacy side of the business, we were shipping through this – under this new format for all of Q2, but only about half of Q2 where we're shipping 3M. And we were shipping obviously both for the full third quarter. So, the actual ramp which John can talk about more, was greater than I think appears when we see flat revenue sequentially.

Before I'll pass it to John, I would say, there's significant amount of cost in the SG&A line from our outbound logistics that manifest from a number of areas, but from shipping partials to other inefficiencies that come through as well. So, we see it both on the top line side and on the OpEx side.

I'll turn to John.

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

A

Yeah. Thanks, Dave. So Brandon, the big issue we have is getting orders to drop in the warehouse from SAP to the SAP module, BWM. And we've got SAP fully engaged with our integration partner, PwC, and our teams try to drive this. And when we talk about the efficiencies, let me quantify it for you a little bit. So, in Q2 about 40% of our shipments happened in less than five days. In Q3, that went up to 80%, right? So, we're making progress. Now the goal is 24 hours, right? You order today, we ship tomorrow. That's what we've done for years and years. So, you saw what happened to our efficiency.

I think the other thing to remember is, as Dave talked about, our shipping in total dollars has grown exponentially, because we brought in the 3M business where we shipped in Q3 152% of what we shipped in Q2. And if you think about Q1, it was 175%, right? So, we really are ramping up the amount of products going out of our warehouse. So, every day we set new records on what we're shipping out, but we have to get that turnaround time back to 24 hours, and that's what we're going to do.

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Okay. Maybe another nearest-term question, but a little more specific on the margins, maybe for Dave. Look, I know we don't have perfect numbers here, so I'm doing rough math, so correct me if I'm off the mark. But if I'm still assuming the 3M business is high-20s, 30% EBITDA margin, it kind of implies a Neogen kind of legacy business, that's 3 or 4 points below what it historically used to be, arguably even potentially a sub-20% EBITDA margin. I guess, one, are we – is that math ballpark correctly? And then two, is that really just all from operational efficiencies?

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

A

There's a couple components here, Brandon. I think it's difficult at this stage in the game to try to look at it as two separate P&Ls. I think going back to kind of history is a little tough there. But I think underlying your question is the fact that we've added significant amount of cost that was necessary to come off the transition agreements and other investments to kind of operate at our new billion-dollar-ish company size.

And by our own admission, we're not where we thought we would be from a revenue scaling standpoint. With the high fall-through, that's been more impactful than we would like to have seen here. And that's something that we need to probably [ph] re-phase (28:32) here as we move into the next year, given kind of the current profile of the ramp. Now, we know the business can come back in a hurry once we get through some of these issues. But since we're behind, we need to probably address the cost structure to some degree as well.

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Okay. And Dave, on that same note, on a follow-up to that, as we start kind of thinking about our fiscal 2025 numbers, I appreciate you guys will give an official guidance on the next quarter probably, but how should we think about the progression of how these things get rectified over the coming quarters and how that kind of translates into EBITDA margins on a go-forward basis, even if you just talk high level without giving us specific numbers?

David H. Naemura
Chief Financial Officer, Neogen Corp.

A

Yeah, let's see where we're at, at the next quarter to your point. But I think what's fair to say about next year is, we should have a bit of an easy compare that's going to help growth next year given some of the constraints we've had this year. So, assuming we rectify things in the timelines that we believe we can, that will be helpful on the growth side.

And obviously, we would see 2025 as a better margin year than we've experienced here in 2024. Beyond that, I want to be careful. Those are the same things you would assume I know, Brandon, but let's get a quarter from now and we'll bring something more [ph] fulsome (29:57).

Brandon Vazquez
Analyst, William Blair & Co. LLC

Q

Okay. And one last one for me. Sorry for a bunch of questions this morning, but maybe, John, for you. As you look high level at the deal, there's clearly – we've all talked a lot and done a lot of work on this. And it seems like there's a lot of opportunities for the company.

But as you look at now kind of a couple of years into this, you're talking a little bit of potential share loss from some customers that you have to go back and win back. What's your confidence? How do you feel about kind of still eventually hitting? I know timing is uncertain, but is this structurally a business that can still do high-single-digit plus growth and a 30%-plus EBITDA margin? Or is there some work that needs to be done in order to give you the confidence that that's the level that this company can be at? Thanks, guys.

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

A

No, I think you're right, Brandon. I mean, the issue is going to be around the timing, but absolutely it can, because again when we talked about those numbers, that was always our jumping-off point from when the businesses are combined. But we knew this was going to be a challenging integration, right?

We weren't the only business that looked at this like the 3M business, but a lot of companies didn't want to take on this type of integration and carve out. And we knew it was going to be challenging. I'm frustrated that it's taken us this long to get two modules between SAP to work together in a way that I think makes it easy for us to do business. And so, we're addressing that.

I think it's a short-term issue, because our customers are on a subscription basis, and when we can't supply them, they can't just stop. So, that's allowed some competitors to get qualified and come in. Now, we've seen that when we have our product and our things in line that these customers come back as we have the best solution. But we've opened the door for some of the competitors to come in. Now, we've seen when we have supply, those customers come back.

We've seen that with growth in other areas. We've seen that with the bounce-back in Petrifilm around the world where we have supply and it comes back. So, I feel very confident about that. But, yeah, look, I'm frustrated and irritated and you don't want to be sitting in my office because this is not generally how we efficiently run our operations.

And while there's a lot of great things we've already done and we've made a lot of progress, I'm not pleased with where we're at today. So, we're going to double down, make sure that we're going to get our customers' needs met. And once we get back to that, I think you're going to see really strong growth rates.

Operator: [Operator Instructions] There are no further questions at this time. I will now turn the call over to the company.

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

Well, thank you all for joining us today. We look forward to talking to you at the end of our fiscal year and we'll talk to you soon. Thank you.

Operator: Ladies and gentlemen, this concludes your conference call for today. We thank you for participating and ask that you please disconnect your lines.