Q3 2019 American Vanguard Corp Earnings Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

- Christopher John Kapsch, Loop Capital Markets LLC, Research Division - MD
- Joseph George Reagor, Roth Capital Partners, LLC, Research Division - MD & Senior Research Analyst

PRESENTATION

Operator

Greetings, and welcome to the American Vanguard Third Quarter 2019 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Bill Kuser, Director of Investor Relations. Please go ahead, sir.

William A. Kuser, American Vanguard Corporation - Director of IR & Corporate Communications

Well, thank you very much, Hector, and welcome, everyone to American Vanguard's third quarter and 9-month earnings review.

Our speakers today will be Mr. Eric Wintemute, the Chairman and CEO of American Vanguard ;and Mr. David Johnson, the company's Chief Financial Officer. Also, to assist in answering your questions, Mr. Bob Trogele, the company's Chief Operating Officer.

Tomorrow, American Vanguard will file our Form 10-Q with the SEC, providing additional details to the results that we will be discussing in this call.

Before beginning, let's take a moment for our usual cautionary reminder. In today's call, the company may discuss forward-looking information. Such information and statements are based on estimates and assumptions by the company's management and are subject to various risks and uncertainties that may cause actual results to differ from management's current expectations. Such factors include weather conditions, changes in regulatory policy, competitive pressures and various other risks that are detailed in the company's SEC reports and filings. All forward-looking statements represent the company's best judgment as of the date of this call, and such information will not necessarily be updated by the company.

With that said, we turn the call over to Eric Wintemute.

Eric G. Wintemute, American Vanguard Corporation - Chairman & CEO

Thank you, Bill. Good afternoon, everyone. Let me start by thanking you for your continued support of American Vanguard. This afternoon, I will begin my remarks with a recap of top line performance and the underlying market conditions. Then, I would like to spend some time on our balance sheet with a focus on demand inventory and factory activity. I will then turn the call over to David who will give you a more complete picture of our 3- and 9-month performance.

After David, I will speak on how we are growing organically through the launch of new combination products, which we call non-acquisition growth. I will then turn to technology development, including our biologic portfolio and SIMPAS. Finally, I will give financial metrics for the full year of 2019 and a general outlook for 2020.

As I've mentioned in our earnings release today, our quarterly top line performance improved by 12% as compared to the same period in 2018, fueled largely by a 27% increase in international sales and, to a lesser degree, by a 3% increase domestically. At the same time, international sales as a percent of total sales rose to 41% from 36% from the comparable period.

Before getting into specific market conditions, it's worth noting that this international expansion did not happen by accident. As late as 2013, international sales accounted for less than 20% of our total sales. Since that time, we have

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more than doubled that ratio even while growing the overall business. We achieved this result because we have operated this business with a sense of agility.

Five years ago, seeing that the growth of domestic markets was trending lower, we deliberately shifted our acquisition strategy towards international markets, such as Central America and Brazil. That approach is paying dividends for us today.

During the third quarter of 2019, a primary driver for international growth was the addition of sales from our Brazilian business, which we acquired last January. Key products supporting Brazilian sales during the quarter included argenfrut and [Red Shield], which are used largely on citrus and [C-crop Teramore], which are biological products used on multiple crops.

In addition, AgriCenter, which sells largely into bananas, citrus and pineapple enjoyed increased sales despite drought in certain regions of Central America. Similarly, Mexico recorded stronger sales for the quarter as they gained further market penetration from the combination products, Bravo, Gesapax and Sable, which we acquired from Syngenta in 2017.

Finally, we had higher sales in Canada largely due to sales of the cereal herbicide Assure II for use on canola and soybeans.

Also note that, along with top line growth, the gross margin percentage for the international business grew to 28% from 25% for the quarter.

I recall Peter Eilers, the Managing Director of our International business, telling our Board this last September, that, for us, the AgriCenter and Brazil operations are early-stage businesses. As we integrate them further, we should continue to see improved efficiencies and higher profitability. In the next stage of development, we will use these businesses as a portal through which we distribute not only third-party products but also AMVAC products, which tend to carry a higher margin. We have already begun this with the reintroduction of Counter into Brazil.

On the domestic side of the ledger, the picture is different. If I had to put it into a single phrase, I would say that we are holding our ground in a down market. Our entire industry has been set back by extreme weather conditions throughout many regions of the U.S., and the domestic market as a whole is expected to decrease by 6% to 12% for the full year.

During the spring of 2019, persistent rain and coal delay, and in some cases, prevented planting entirely, which in turn, reduced demand for many of our at-plant products. That weather pattern was followed by extreme heat and aridity in the southern region during the third quarter, which in turn reduced demand for our defoliants and post-harvest burn-down herbicides. In particular, our cotton defoliant, Folex, was down $10 million quarter-over-quarter, which would have translated into $0.10 a share for the quarter in addition to our $0.11.

In light of industry-wide trend, the fact that we recorded increased domestic sales in the third quarter is encouraging. Also, our 9-month performance shows a 3% decrease as compared to the same period in 2018. From this, we can surmise 2 things. First, our domestic performance has turned for the better since the start of the year. Second, if we continue on our current trajectory in U.S., with respect to the top line, we should outperform the industry average through year-end.

Let's take these market conditions in hand, and we weighed into how they affect our balance sheet. I'll let David get into how these matters affect profitability.

As you know, we manufacture about half of our products, including many high-margin products that are sold domestically. When demand for these products is under pressure, as for example, when there are adverse weather conditions, we dialed down manufacturing activity in order to control inventory. We did this with Thimet and Counter earlier in the year and with Folex midyear. Bear in mind, that through our SIOP program, we build to meet expected demand. However, when the demand slips unexpectedly, we adjust our procurement and factory planning over future periods.

Now let's turn to recent history, and I'll demonstrate how we have responded to managing production and inventory in light of actual demand.

We started 2018 with inventory at $123 million. At that time, we have just acquired AgriCenter as well as the Abba, Equus and Parazone product lines. In order to meet the expected demands for both current and new businesses, we both built and procured inventory. With that activity in 2018, we recorded the best factory under absorption numbers in our history. At the same time, in order to optimize tariff expense, we like many in the industry, expedited imports of certain products from China.

In the end of 2018, we added the Assure product line. And with that, our inventory stood at $160 million.

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With reduced domestic demand in the first half of 2019, however, our inventory levels rose to a peak of $193 million. At the end of the second quarter, while at the same time, we were pulling back on factory activity to a degree.

During the third quarter, we decreased the inventory level to $186 million, and we expect to reduce inventory by another $36 million to end at about $150 million by year-end.

I'm confident that we can bring inventory down to meet our forecast. We have done this before in much more difficult circumstances. As you may recall, following an industry-wide oversupply in 2013, we were compelled to hold down factory activity and sell into a saturated market while maintaining brand value. By contrast, the circumstances of 2019 are far more mild.

In light of these considerations, one might ask where we stand on our acquisition strategy. On that subject, I would say that while we remain active in looking for accretive opportunities, we are mindful of our key objective to reduce debt, closely manage working capital and strengthen the balance sheet.

Let me pause at this point and turn the call over to David who will elaborate further on selected financial metrics as well as upon overall financial performance. David?

David T. Johnson, American Vanguard Corporation - VP, CFO & Treasurer

Thank you, Eric. Good afternoon, everybody. As Bill mentioned, we will be filing our Form 10-Q for the 3 and 9 months ended September 30, 2019, tomorrow.

With regard to the financial results, as Eric just detailed, the company's sales for the third quarter of 2019 increased by 12% to $125 million as compared to $112 million this time last year. Within that overall improvement, our U.S. sales were up 3%, while our international sales grew by 27%.

As Eric mentioned, notwithstanding the strong growth in our international portfolio, the primary reason for our falling short of the net sales consensus was the extremely hot weather conditions in the southern U.S., which impacted our cotton defoliant sales and limited our domestic ag sales growth to 1%.

Our domestic non-crop business, on the other hand, had a strong quarter with sales up 10% driven by demand for both our Dibrom mosquito products and our pest strips.

As Eric mentioned, during the quarter, we continued to focus on our manufacturing plan and our inventory levels. The unusual extreme temperatures I just mentioned, following wet conditions in the Midwest earlier this year, has had an impact of somewhat undermining our steady progress on inventory as we worked through the current growing season. The change in manufacturing activity and associated recovery of overhead costs, coupled with faster growth in our international markets, contributed to a decline in quarter-over-quarter gross margins to 38%, which is in line with our comments during previous calls.

Also, during the quarter, our operating expenses ended at 33% of net sales compared to 30% this time last year. This change was driven by a few factors. First, we have acquired a number of new businesses and products in the intervening 12 months. And second, we made quarterly fair value adjustments related to liabilities associated with some of our past acquisition transactions.

In 2019, these benefited operating expenses in the amount of $650,000. By comparison this time last year, the required adjustment amounted to $4 million. Absent these nonrecurring beneficial adjustments, our operating costs would have been 33% in the third quarter of 2019 and 34% in the same period of 2018.

As expected, our interest expense increased driven by our acquisition activity over the last 12 months, our higher working capital levels and increased LIBOR-based interest rates. These various dynamics generated net income of $0.11 per diluted share, which was in line with the level we predicted when we provided the market with a pre-announcement on October 15.

For the 9-month period ended September 30, 2019, net sales were up 5% at $338 million as compared to $323 million for the same period last year. Gross margin was at 39% which is also in line with the levels we have indicated in previous calls.

Our operating expenses, when expressed as a percentage of sales, increased to 33% as compared to 32% in the first 9 months of 2018. In 2019, operating expenses included lower legal costs and a breakup fee on a potential acquisition when compared to the same period of the prior year. Offsetting these beneficial changes, we have picked up additional expenses necessary to manage the products and businesses acquired since this time last year as well as a decrease in fair value adjustments to acquisition-related deferred consideration.

Our net income for the first 9 months of 2019 amounted to $10.2 million or $0.34 as compared to $16.8 million or $0.56 in the same period of 2018. From my perspective, the financial focus of the company remains consistent. First,

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we continue to follow a disciplined approach to planning our factory activity, balancing overhead recovery with demand forecasts and working to optimize inventory levels. At the end of September 2019, our inventory levels were down slightly when compared to the first and second quarters of 2019, though higher than those at 2018 year-end. This is a normal pattern for the company as we work through our annual manufacturing plan.

Generally, our sales activity is stronger in the final 2 quarters of the year and requires higher inventory levels in order to meet customer needs. At the end of September, for example, our distribution businesses in South and Central America were in the midst of their busy season. Our ag market was in the middle of the fumigation period. And finally, sales were beginning to ramp up for the start of the 2019/'20 growing season in the Midwest United States.

Given our final quarter forecast and our annual manufacturing plan, we expect to see inventories reduce to about $150 million by year-end, which is revised compared to the previous target of $145 million. Second, our effective tax rate ended at 28.2% year-to-date, which is exactly in line with 2018. The drivers, however, are different.

In 2019, we have seen strong growth in our international businesses and especially in countries with higher tax rates when compared to the U.S. At the same time, our domestic ag market has been comparatively weak. Conversely, in 2018, both our domestic and international businesses were performing strongly. And in addition, we took a onetime tax expense related to the implementation of the Tax Cuts and Jobs Act, which did not repeat in 2019.

The current year-to-date rate reflects some changes in the latest country-by-country tax forecast regarding the mix of where we expect to make profit in 2019 that differs from earlier in the year. We continue to analyze our projected regional mix of taxable income as we integrate our recently acquired products and businesses. At this point, we are adjusting our tax rate expectations for the full year to between 28% and 29%.

Third, with regard to liquidity. At the end of the third quarter, availability under our credit line stood at $30 million as compared to $105 million this time last year. This is broadly flat with the position I reported when we last briefed investors. The change in liquidity in comparison to this time last year is due to increased borrowings in the second half of 2018 and the first 9 months of 2019 in order to buy a number of products and businesses. Further because of challenging weather conditions in the U.S. this year and the different business dynamics of managing the needs of our expanded international business, we have seen an increase in working capital.

Indebtedness as of September 30, 2019, was $165 million, which as we forecast on our last call, is flat with our position at the end of the second quarter.

At December 31, 2018, our debt stood at $97 million. Since that time, we have purchased the distribution businesses in Brazil and completed a small acquisition in this current quarter. In the fourth quarter, we are expecting to see debt decline by about $40 million.

In summary, when looking at our year-to-date financial results, we can say that we have recorded significant international sales growth and a strong domestic non-crop sales increase, offset by U.S. ag market, which has had a generally challenging year as a result of some extreme weather conditions. Furthermore, even while handling strong international growth, generally at lower average margins and holding back manufacturing to control inventory levels, we have succeeded in maintaining our overall gross margin performance.

Our operating expenses have increased primarily because of acquisitions completed in the last 12 months, and when adjusted for fair value reassessment related to deferred consideration have remained approximately flat when expressed as a percentage of sales.

At this point in 2019, I can assure you that, as Eric has emphasized, we are fixed on improving the balance sheet and exercising financial discipline while positioning ourselves to meet demand across multiple markets.

With that, I will hand back to Eric.

Eric G. Wintemute, American Vanguard Corporation - Chairman & CEO

Thank you, David. Now I'd like to turn from market conditions and the balance sheet to areas of growth and our future outlook.

While we have successfully grown this business through acquisition, we are working diligently on non-acquisition growth as well. By developing new formulations of existing products and offering combinations of both old and new products, we continue to bring new solutions to our customers. Among the highlights of new product launches in 2018 are ImpactZ, the corn herbicide; Index, a liquid version of SmartChoice; and NAVIGATOR SC, a non-crop insecticide, followed this year by Oximus, a non-crop fungicide; Krovar DF, a Bromacil-based herbicide and Force 10 GHL.

In 2020, we expect to introduce 2 new impact combinations and 3 products to use in SIMPAS, Counter 20G; corn and nematicide; AZTEC HC, a corn insecticide; and a zinc-based soil nutrition product.

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Taken together, products under development for introduction in the next 2 years to generate sales over $80 million of maturity. In addition, we have been quietly developing and marketing a stable of high-margin, high-growth biological products. As you may know, biologicals are a category of agricultural products in which the active ingredient consists of or is derived from a living organism. They are designed to increase food availability with a low effect on the environment.

As of today, we offer over 60 biological solutions globally including biochemicals, such as botanical extracts, and lemongrass oil; biostimulants, including [Racino] steroids and seaweed; biofertilizer, like boron and copper; and microbials. These products generate sales of nearly $20 million today, and we expect that volume to double by 2022.

In addition to product development, we continue to advance our suite of SIMPAS precision application technologies. In 2020, we have assembled a team of growers, retailers, distributors and peers to host full beta testing on multiple units. This is an exciting part of the rollout as it integrates multiple layers of the entire crop put -- input channel. And agronomists will provide the grower with a prescription for an app plant treatment, that grower will purchase SIMPAS products from retailer and apply rootworm insecticide and nematicide, micronutrient on his or her field as needed, where needed. Positive results should lead to additional pull-through support from growers and agronomists and push through support from retailers and peers.

From technology, let's turn to our full year forecast. I have to admit forecasting domestic sales has been a challenge this year. Nevertheless, in certain important markets, such as row crops, channel inventory of our products is at relatively low levels. Further, the application of post-harvest fumigants typically applied in the third quarter may, in some cases, be pushed into the fourth quarter.

For full year 2019, we expect that net sales will be around $475 million, gross margin will be approximately 38%, operating expenses about $155 million and an overall tax rate in the neighborhood of 29%. By year-end, we have targeted additional reduction in inventory of about $35 million and a reduction in debt by about $40 million.

As of 2020, we forecast overall growth at the top and bottom lines. As I mentioned earlier, we continue to gain traction in Central America, Brazil and Mexico, where the total available market is significant.

On the domestic front, assuming a return to more typical weather patterns and taking into account low levels of row crop inventories in the channel, we expect stronger sales of higher-margin products and incrementally higher levels of factory activity. Also, we have succeeded in securing a source of certain products that were in short supply in 2019. For example, we sold out of Bromacil last April, but have just received the first of multiple shipments, which should generate sales of over $10 million per year with higher-than-average margins.

In summary, year-to-date, we continue to assimilate the effects of the U.S. market conditions. Because of our manufacturing model, which permits us a degree of freedom from foreign suppliers, it takes time for us to recalibrate factory and procurement activity. Nevertheless, we are fully committed to bringing down inventory to lower levels, generating cash and controlling operating expenses.

In parallel, we will seek to gain greater efficiency from newer businesses to expand, including through non-acquisition by means of combination products and biologicals and to advance our SIMPAS precision application technology.

Through these means, we'll be well positioned to deliver improved results during 2020, which I will cover in greater detail in our next call.

And now we'll field any questions you may have. Hector?

QUESTIONS AND ANSWERS

Answer – Operator: (Operator Instructions) Your first question comes from the line of Joseph Reagor with Roth Capital Partners.

Analyst: Joseph George Reagor, Roth Capital Partners, LLC, Research Division - MD & Senior Research Analyst

Question – Joseph George Reagor: I guess the first thing to -- just to be clear, what is the inventory goal for year-end?

Answer – David T. Johnson: $150 million.

Answer – Eric G. Wintemute: Yes. $150 million, $150 million.

Question – Joseph George Reagor: Okay. And then kind of a bigger picture question. What do you think the net impact of weather has been for you guys this year, maybe on a percentage of sales basis?

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Answer – Eric G. Wintemute: Well, I guess I mean, we're -- from our expectations, it's much bigger than where we are year-over-year. I know -- I mean most affected that we talked about defoliant -- the cotton defoliant, that was 10 and 10. Parazone and chlorthalonil, I'm trying to think between the 2. Just trying to think -- let me just take a quick look here for the quarter. Let's see, paraquat, yes, just like -- if you're talking year-to-date maybe, is that what you're asking year-to-date or just recorded?

Question – Joseph George Reagor: Or just -- I mean based on the $475 million number you're planning for the full year, what would you say compared to -- I think you guys started out expecting like $525 million. What would you think like, is that entire gap weather? And if so, like, theoretically, should we be assuming that next year, normal weather year, you get all that back?

Answer – Eric G. Wintemute: Much of that is. We did have the supply position on Bromacil that probably contributed about $7 million. That again, we're looking to get back. And I think generally, outside the U.S., so far, we're fairly close to expectations.

Question – Joseph George Reagor: Okay. And then on margins, a lot of the acquisitions you made for slightly lower-margin businesses. They were hoping to maybe see improvement on looks like this year margins. They're expecting the 38% range. Is there any chance that those might track back up towards 40% over time? Or is 38% kind of a fair number moving forward?

Answer – Eric G. Wintemute: Well, we -- as we said, I mean, we've made progress in the international piece, which I think we're at 25%, we've moved to 28%. So that makes a big difference as we start calling out products that are less profitable.

We have been impacted by particularly typically paraquat and Equus where those products are basically all imported. And with those markets not materializing, our competitors are sitting on large inventories as well, and that has dampened the margins there.

So our goal certainly is to increase margins. I think we see -- as we mentioned, the biologicals as that plays out where those are higher-margin products. SIMPAS, we expect to be higher-margin products as well. And then there's royalties coming from that and from the Procter & Gamble, TyraTech, Envance deal which again, obviously, improves margins because it's a straight royalty payment. So I just answered your question, yes, we would look to move margins up as we start gaining synergies moving forward.

Answer – Operator: (Operator Instructions) Your next question comes from the line of Chris Kapsch with Loop Capital Markets.

Answer – Christopher John Kapsch: Just wanted to try to understand the impact that the reduced sales is going to have on gross margin from a timing standpoint. I know you're working to reduce inventories. Do you think that, that, that drag on gross margin persists into 2020? If so, for how long? And then if you could frame up any sort of metric a little bit more -- with a little bit more specificity as suppose -- regarding the potential gross margin performance in next year, given that you will have some -- it sounds like several -- at least a couple of positive mix contributors next year.

Answer – Eric G. Wintemute: So with regard to factory performance, we do see improvements. That being said, we do have some holdovers, such as the Folex inventory that we talked about provider in insecticide also. So those will be kind of negatives. But I do think we feel our corn products look pretty strong. And again, we build for the 2021 season, third and fourth quarter and into first quarter. So that'll have -- the '21 will have a positive effect as well and the '20.

So we'll see improvement there. As far as -- I think your second question was regarding -- what was the second question? Margins for 2020 or -- you mean the products for 2020...

Answer – Christopher John Kapsch: Yes. Yes.

Answer – Eric G. Wintemute: Was that your question, the products...

Answer – Christopher John Kapsch: Yes. If we could try to frame up what the gross margin improvement expectation might be for 2020 based on -- obviously, there's a lot of moving pieces, but based on the fact that you will have mix improvement next year?

Answer – Eric G. Wintemute: So I don't know that we've got -- I mean we still have inventory that we need to move in 2020 that has competitive hangover, I would say. And then it's a function of the tariffs. If the tariffs were to go into effect with, then we're sitting in a good position with inventory.

If they don't, then that will continue to be a drag for us on those products that are -- that we sell that are generic. And we're not a great generic competitor because we do have kind of minimal margins we try to make. And we have -- we are full service, and we offer support to our customers.

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So that will be a little bit of a drag. We'll pick up in the Bromacil because that's a high-margin product, which I mentioned will be $10 million next year, which is at higher level margin. So I guess we've tried to tick up 1% maybe from 38% to 39% for this next year.

Analyst: Unidentified Company Representative,

Question – Unidentified Company Representative: I think that's reasonable.

Answer – Eric G. Wintemute: I think that -- we're looking at.

Answer – Christopher John Kapsch: And then -- so Eric, going back a few years, there was a pretty pronounced down cycle in corn post the 2012 drought and then issues in 2013 and because of your experience then, but you've taken measures to improve the visibility you have with sort of channel inventories. And you mentioned in this call you feel pretty good about where channel inventories are, can you just talk about like what gives you the confidence on surrounding that visibility because it's a little counterintuitive with the weak sales here that there might be a little bit of a challenge for 2020 with the overall industry having maybe surplus inventories in the channel?

Answer – Eric G. Wintemute: Yes. I mean the pre-emergence got hit probably the hardest. Our post-emergent index -- or impact did well. Our corn soil insecticides actually did even better. And so with the returns coming back from the channel were less than they have been in previous years, both on a percentage basis and on net volume.

So that -- you kind of told us that on ground was better than sales would have indicated. And that being done in a very challenging year, where a lot of acres either didn't get planted or didn't have time for treatments and expectations [weren't] particularly high. I think our team is somewhat optimistic about the prospects for 2020.

Answer – Operator: (Operator Instructions) Ladies and gentlemen, we have reached the end of the question-and-answer session, and I would like to turn the call back to management for closing remarks.

Answer – Eric G. Wintemute: Thank you, Hector. I appreciate everybody participating on the call. We look forward to giving you further progress as we move through this final quarter. Thanks very much. Bye.

Answer – Operator: This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.

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