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Zoetis, Inc. (ZTS)

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CORPORATE PARTICIPANTS

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

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Derik de Bruin
Analyst, Bank of America Merrill Lynch

MANAGEMENT DISCUSSION SECTION

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Good afternoon, everyone. Welcome to the Bank of America 2017 Health Care Conference here in fabulous Las Vegas. I'm Derik de Bruin, the Life Sciences and Diagnostics Tools analyst, CROs, and more recently animal health; jack of all trades, master of none.

It is my great pleasure to kick off the afternoon session today with Zoetis. With us today is CEO, Juan Ramón Alaix. We're going to do this all as Q&A style, fireside chat, and I'm going to – I've got a ton of questions to ask, but I'll open it up to audience in a little bit and we'll kick if off from there.

QUESTION AND ANSWER SECTION

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

So, Juan Ramón, let's talk a little bit about Q1. I mean, you were up against the toughest comps for the whole year. You had the MFA directives coming in. You had operational headwinds coming in. Gross margin hit from the recognition of COGS at the end of Q4. And despite all these factors, you still had a really solid, very strong quarter. You beat the Street estimates. The rest of the year looks quite favorable. And certainly you're 6% to 6.5% midpoint of your [indiscernible] (01:12) achievable. I guess sort of talk about sort of the pacing through rest of the year. This strength continuing, what's been the drivers of this surprising strength despite all these headwinds?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

Well, the first quarter has been definitely very positive, because this growth of 6%, even with all the different headwinds, SKU rationalization, different days in terms of sales had also a negative impact. But what we see is the confirmation that the guidance we provided for the year, 5.5% to 7.5%, it's strongly supported by our initial performance in the first quarter.

Companion animal has continued growing, the growth in the quarter and we expect that also will continue growing faster than this 5.5% to 7.5% as an average that we have for the company. So very pleased with the performance of APOQUEL, CYTOPOINT, very pleased also with Simparica that now it's also performing extremely well. And the strategy that we developed to support the product, with change in distribution and also ensuring that we are getting the right level of share of voice, it's doing extremely well.

We also discussed during the quarter the negative impact of the new Veterinary Feed Directive. It had an impact in the first quarter, higher than initially expected, because we expected that the livestock operation will adjust faster into the new guidelines. But we saw that smaller customers without veterinarian staff in their operations, they have difficulties to adapt that. But we see that in the next coming quarters they will learn how to manage this new directive, and also will have – reduce the impact on our revenues.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

So that's interesting comment. Like you, I would have assumed based upon the calls that we've done that people would have adjusted a lot faster on the market. But still then, U.S. livestock was only down 3% in the quarter. It all wasn't all the MFA initiative, right? Were there any weather or any other timing of items that were going on in the U.S. livestock in the quarter?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

Well, in the U.S. we saw that it was milder winter than average. When we have these type of weather conditions, especially in the cattle business, in beef, they keep the animals longer on grass. They don't move the animals to the feedlot earlier in the process of gaining their weight. So most of these animals, when they got into the feedlots, they were heavier. When they are heavier, they have – the risk profile in terms of diseases is lower. And this was something that had an impact in the first quarter. But also we mentioned that we had a negative impact of the SKU rationalization in the livestock, mainly affecting swine and poultry.

We expect also that the second quarter will be affected because of that, and then third and fourth will be normalized situation in terms of SKU rationalization. But still, if we saw some probably headwinds in the first quarter in livestock, we're still optimistic about livestock. Prices are moving into the right direction. So it means that the price of pork, poultry, beef, milk are growing. This will also increase the opportunity for our customers to be much more profitable.

We have seen already that animals are moving to the feedlots in the U.S. medium size, not heavier as in the first quarter. Placement in the feedlots are also growing. So we remain positive about our livestock business.

Derik de Bruin Q
Analyst, Bank of America Merrill Lynch

So we just picked up coverage of the stock in September, and as I've been marketing the stock and talking with investors about it, I mean, one of the comments that keeps coming up has been people are sort of looking at the long-term demand for protein and basically the argument that there's going to be a move away from cattle more towards poultry and swine over time, as we look at where the populations are growing. So how do you look about your portfolio and sort of what are you sort of thinking about in terms of sort of that argument that beef consumption is going to decline and these are the ones you're going to be certainly sort of greater growth?

Juan Ramón Alaix A
Chief Executive Officer & Director, Zoetis, Inc.

I think probably the beef consumption as beef per capita will decline, but it will be much more people eating beef than in the past. We only consider China. China, 1.3 billion people. Even if they increase only 1% the consumption of beef, it will not be enough cows in the world to feed this additional need. So I think it's something that beef will be definitely much more expensive.

It's more expensive also because the rate conversion of food to proteins on beef is less favorable. But still, there are many people in the world that they are willing to pay a premium price for beef. They enjoy a good steak, and we see that even with maybe the increase of chicken or swine will be faster, beef – or the animals or the cows will be very valuable, and then keeping these animals healthy also will be something very important for farmers. And this is where we can also provide value to our customers with the right vaccination and the right treatment for keeping these animals healthy and productive. The other area that is probably less important today in livestock is fish.

Derik de Bruin Q
Analyst, Bank of America Merrill Lynch

Yeah.

Juan Ramón Alaix A
Chief Executive Officer & Director, Zoetis, Inc.

Fish is growing very fast. We are now participating in this market with acquisition of PHARMAQ, especially in vaccines where we see the biggest opportunity. Still small part of livestock business, but there's a lot of use of antibiotics in the production of fish that we expect that will be moving to vaccination, and this is where we think that will be the biggest opportunity.

Derik de Bruin Q
Analyst, Bank of America Merrill Lynch

So the – I think one of the misconceptions on the stock when we were talking with investors or just in general when we were ramping up is, they see you have $1 billion plus in sales of antibiotics, but only a small exposure to the medicated feed additives. So can you sort of like – I think we were estimating around $50 million of exposure. Is that still a reasonable number with that – to like that? I guess, could you talk about opportunities for sort of moving – opportunities for vaccines and other products to sort of replace that?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

Well, we see that – the needs of treating animals which are sick will remain. So there is no alternative to antibiotics today when an animal is sick and also – in many cases also, you want to protect your herd against an infection. When an animal has been identified as sick, unless you protect the rest of the herd, you have the issue of having all your animals infected. And when they're infected, you have the risk of dying if you are not treating or not being productive. So this is something that we are convinced that antibiotics will be growing at a much lower rate than the rest of the industry. It will continue challenge in terms of the use of antibiotics, and we'll be working on identifying what will be the alternative to antibiotics in the future. It is part of what we are doing in terms of our efforts, in terms of R&D.

The impact of the pressure of antibiotics is very different in different geographies. In the U.S., the focus has been, well, in two areas. So, one, it's eliminating medically important antibiotics with indication of growth promotion is something that's been implemented with a minimal impact in our sales. The second, it's ensuring that veterinarians are always involved in the use of antibiotic. This is the Veterinary Feed Directive what we described the impact, but again, so we think that it's an area that it's manageable. Another different discussion is that what is the pressure, not from regulators, but from consumers...

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Right.

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

...or even producers or retailers in moving to less use of antibiotics. And here we have seen, especially in poultry, that some of the producers, they have been communicating that they are moving to antibiotic-free. [ph] If you read (11:00) carefully the communication is not antibiotic-free, but non-medical important antibiotics used in the production of chicken. And the advantage for us is that we have products in both categories. And we have seen in some cases that it can be net positive to us if they are moving to non-medical important antibiotic, because some of these products are in our portfolio and they are, well, with higher price and, also in some cases, higher margin.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

So when you look at all the factors that are impacting the production in animal business over the next couple of years, it's like how do we think about a steady-state or what would be – what's a good sort of, like, organic revenue growth, core growth number for that market – or for your business? I mean, how do you think you're going to be growing the business?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

Well, let's start with the description of what we expect the market growing in the next five or even longer period of time. Well, we have been 5% to 6% in the past. We expect that we'll continue growing at 5% to 6%. I have seen recent projections of Vetnosis indicating that the growth will be around 6% in the next coming years. What are the sources of this growth? Well, half of this growth will be price, and then on the other half, two-thirds will be volume of the existing products, and one-third will be coming from the introduction of new products.

When companies will be growing faster than this 6%? Only when they have success in their investment in R&D. And this has been the case for Zoetis. We have been growing faster than this market average because of our success in bringing new products into the market. But the rest of the driver has been very consistent for most of the animal health companies in this space.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Great. R&D and new products is a great segue into the companion animal market. You've had APOQUEL. Very robust 2016. 2017 is off to a great start, $77 million, I believe, in revenues for the dermatology franchise as a whole in the first quarter. So could you sort of talk about that portfolio and sort of like how to think about the relationship between APOQUEL and CYTOPOINT potential synergies and any potential cannibalization in that market and just sort of talk about the overall dermatology franchise?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

Well, they are both products in the same dermatology area. We consider that both products are very complementary. And APOQUEL is a product that is responding extremely well to these dermatological conditions. But for those dogs that either are not responding well to APOQUEL, very few, but some, or the way of treating will be not oral, but injectable, then CYTOPOINT will be an excellent alternative.

We thought initially that it would be distribution 80/20. Maybe it will be different, but what is important for Zoetis is that we have now into the market what we consider is best-in-class options for treating atopic dermatitis, allergy, itching conditions. And now, the veterinarian, they have an excellent two products to cover all the spectrum of needs. But still, we see in the U.S. significant potential of continue growing.

Recent data is indicating that combining APOQUEL and CYTOPOINT, we have a little bit more than that 50% of patients. So still a lot of dogs are using steroids. Over time, we expect that this will be moving to either APOQUEL and CYTOPOINT. And there are other products or shampoos or things that, in our opinion, are representing also additional opportunities for CYTOPOINT and APOQUEL. We are not trying to promote one product against the other. What we are providing is this is what you have for covering all the needs of your dogs in terms of dermatology issues.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

So you started some DTC campaigns for APOQUEL recently, and as well as Simparica. Have you seen any sort of like uptick in demand as a result of these investments?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

Well, for APOQUEL, we had the experience of the pilot that we conducted last year. We selected some cities in the U.S. We tested what was the impact of different options. One option was only promotion through our field force. The other one was adding publications or advertising in magazines. And the third was combining all the three, including DTC. The best result was combining our efforts with our field force, also publications, and then direct-to-consumer advertising.

So based on this experience, we launched full campaign in the U.S. We started in April. It's too early to see how much is the impact coming from this investment, but we are convinced that will bring more patients, more pet owners to the clinics. And because – so the options that they will find in the clinics will be APOQUEL and CYTOPOINT, and they will leave the clinics with one of the two products.

Simparica maybe a little bit different. In Simparica, we saw the need of increasing our share of voice. We are competing with a strong brands in the market, NexGard, Bravecto, Merial [indiscernible] (17:33), and Merck. And we definitely continue having our field force promoting the product. But we also added the share of voice when we changed our distribution strategy involving also distributors in their promotion of Simparica, and then complemented with DTC, which are also matching the efforts that the two biggest competitors are also applying into the market.

Derik de Bruin
Analyst, Bank of America Merrill Lynch **Q**

So if you were to take out the contributions from APOQUEL, Simparica, and CYTOPOINT, what's the core growth – what's the core animal health business growing, the other products, the underlying growth of the business outside the new products?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc. **A**

So the growth excluding that in companion animal?

Derik de Bruin
Analyst, Bank of America Merrill Lynch **Q**

Yes, yes.

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc. **A**

Well, I think it depends also the markets In the U.S., in the first quarter, I think excluding all the different impacts that are affecting the quarter, maybe the growth it's flat in terms of volume. We are generating growth also in terms of price. Again, so these – it depends on the quarters. It depends on many different factors. As I said, in the model that we are projecting, we expect that we generate growth also in companion animal coming from price. Also volume of the existing portfolio and growth coming from the introduction of new products.

So it's difficult to extrapolate the results of one quarter to the rest of the year. We are still confident that we have very strong portfolio of vaccines. We have a strong portfolio of other medications, and now we adding very strong portfolio for parasiticides and APOQUEL/CYTOPOINT.

Derik de Bruin
Analyst, Bank of America Merrill Lynch **Q**

And what other new products are sort of in the pipeline for the companion animal business?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

Well, we mentioned that they have two drivers of growth that we expect in the future. One will be the platform of monoclonal antibodies. So we gain significant experienced with CYTOPOINT, experience in R&D, experience also in manufacturing, and we identify an external opportunity to complement our internal investment that – it was Nexvet.

With Nexvet, we expect that we will also develop new products in pain coming from monoclonal antibody, pain for dogs and pain for cats. Dogs, well, we have a significant presence in this area. So with this investment or with this acquisition, we are strengthening and protecting our leadership in the pain market. And we see also the opportunity of expanding to an area that it's unmet need, which is how to treat pain in cats. Treating pain with a pill in cat, it's almost impossible. So we think that an injectable formulation for cats will be the right treatment, the right administration that will expand the market significantly, so this is one area of investment.

The other platform that we define as a platform is sarolaner. Sarolaner is the active ingredient of Simparica. We are already expanding the use of sarolaner with combination with other active ingredients. Has been the approval – recent approval in Europe of the combination of selamectin, which is the active ingredient of Stronghold revolution with sarolaner. And we are working also – and this is for cats. It's a topical formulation. And we are working in dogs combining sarolaner with other active ingredients to expand the protection of parasiticides, including external, fleas and ticks, with internal, heartworm. And this is an area that we are working. We are also trying to develop long-acting formulation for sarolaner injectable formulation also combining different active ingredients.

Another area of investment is identifying products that will be increasing the feed efficiencies and will maybe in the future replacing existing technology, hormones or beta agonist, that at this point are more and more challenged by the consumers. And maybe also, we are working also in identifying new classes of antibiotics that will be targeting animals and will not create resistance in human. We'll continue working on many different areas to ensure that Zoetis, it's bringing the next generation of innovation, as it has been in the past in the animal health industry.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

So that's a great segue into my next two questions. And the first one being you are investing in R&D. You've done the Nexvet acquisition. So, how do we think about operating margin expansion? You had a great track record recently [indiscernible] (23:00) margins. Another frequent question that we get is like, where do they go from here? What's the target over the next couple of years for the op margin?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

Let me start saying that, definitely we have been growing margins in a very positive way. Last year, we reported an EBIT margin of 32%, 400 basis point improvement compared to 2015. This year, we are targeting 34% to 35%, another nice improvement of 200 to 300 basis points. What is from here? So we'll continue applying a model that will support margin expansion. We have another opportunity with our plant network strategy, where we are transferring products from different plants, also eliminating some additional manufacturing plants to increase – to be more efficient in terms of the absorption of overheads.

And we will be targeting growing revenues in line or faster than the market, this 5% to 6%. We'll continue ensuring that we have a discipline in terms of expenses, growing expenses in line with inflation, identifying opportunities in being more efficient in G&A, and using these efficiencies to invest in generating growth.

In R&D, we want to invest to maximize growth in the future and to support our growth. And even if it's natural that we are growing our margins, I think the most important thing is that we'll continue focus on generating profitable growth. And we are not missing opportunities to invest in the business, in commercial, in R&D, in manufacturing, to support this aspiration of – or objective to have growth that will be in line or faster than the market for a company that already has a significant market share.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

So, you mentioned the Nexvet deal is an acquisition that you've done recently. I think capital deployment is a question that keeps coming up with this. It's like, how do we think about your use of the balance sheet, capital deployment, other areas of interest, diagnostics, more aquaculture genomics? I mean, how do we sort of think about where the company wants to go from an inorganic perspective?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

I will say all of the above. And first, we want to make sure that we have the right allocation of capital to our internal efforts and commercial, R&D, and manufacturing. We have been now expanding field force in areas where we saw the opportunity of generating growth, in China, in Brazil. We'll continue assessing that, what is next, to ensure that we have the highest penetration into the markets, in R&D – but we also invested in DTC. In R&D, I think it's something that we don't want to be cheap. We want also to have clear metrics, clear return of investment. But we don't want to miss opportunities on investing R&D to generate future growth and also, in some cases, we are adding new technology – new products that also require investment in manufacturing. So there is the first priority in terms of capital allocation.

M&A is the second priority, and we'll continue assessing opportunities in our core business. Nexvet is a good example of investing in our core business. We'll continue assessing opportunities on how to enhance our presence in some of the emerging markets with potential local companies.

And we see also the opportunity of increasing our market share in what we define as complementary spaces, and we define as complementary because there are spaces in where we don't need to fully develop our infrastructure. We can maximize the infrastructure that we already have in terms of commercial, R&D, and in some cases manufacturing, to expand to areas like genetics, diagnostics, and [ph] biodevices (27:34), and this is something that we'll continue assessing what are the opportunities that are in the market and we'll complement these opportunities with our internal efforts.

In diagnostics, we recently acquired Scandinavian Micro Biodevices, and we are convinced that it's providing to us the platform to be active player in diagnostics in equipment, with the introduction of a product that in some cases they have the potential of being disruptive in terms of technology and innovation.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

I guess in the remaining few minutes, as you talk with investors, what do you think is the biggest misconception about the company, what's misunderstood, what don't people appreciate about Zoetis?

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

Well, I think it's maybe one frequent question that we get. It's, well, the impact of generics in our business. And this is something that even if we explain from the beginning that our industry is so different than human health and the impact of generic competition exists, but it has completely different impact, is something that from time to time some people are still thinking that we have significant risk because of this generic competition. This is one of the areas that, in my opinion, need some explanation. Most of the things – I feel that now after four years in the market, we have been provided good details of animal health and the differentiation with human health in many different aspects.

It's a business that is not dependent on third parties, which is an element that is also providing good stability and less dependency of political decisions. R&D, it's showing high level of productivity, and it's a business which is driven by economic dynamics. Not things which are outside of our control. So I think it's step-by-step, I think in my opinion, the people understand this business and also appreciate the opportunity of investing in animal health.

The other area that it's still creating concerns is these fluctuations, and the impact of price, the impact of winter. It's part of our business.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Yeah.

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

A

And it's something that we have been managing forever and will continue managing. One of the advantage of this industry is very predictable and also resilient to economic crisis. And Zoetis, it's probably the best example of resilient, diversity, and how we can manage cycles, because we are not dependent on one country or one species or one therapeutic areas. We have a high level of diversification, which is helping us also to mitigate potential risk or cycles.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Great. And with that, we're out of time. Thank you very much, Juan Ramón.

Juan Ramón Alaix
Chief Executive Officer & Director, Zoetis, Inc.

Thank you.