

26-Sep-2017

Zoetis, Inc. (ZTS)

Cantor Fitzgerald Global Healthcare Conference

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MANAGEMENT DISCUSSION SECTION

Louise Chen

Analyst, Cantor Fitzgerald Securities

Hi, good morning. I am Louise Chen, I am the Specialty Pharma Analyst here at Cantor. I wanted to introduce to you Juan Ramón, who is the CEO at Zoetis. We're going to be hosting a fireside chat with him. I'll ask him a bunch of questions and then at the end we can open up to the audience if there are any questions from the audience.

So, before I begin, do you have any opening remarks, or do you want to just get into the questions?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

No, let's go the questions. Thank you.

QUESTION AND ANSWER SECTION

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. All right. So, first question I had is, if you could provide an update on the macro factors that affect the livestock business and how healthy these trends look for the foreseeable future, what do you see as key tailwinds and headwinds in swine, poultry and beef and how could these affect your sales in 2017 and beyond?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

Okay. Thank you for – these were general questions. So, the macro trends that are affecting our industry are related to, first, the consumption of animal proteins, which are related to the number of people in the world, the population, also the middle-class increase and also the urbanization. So, all these three elements are defining not only the consumption, but also how the animal proteins are produced.

Also, the same elements, population and middle-class growth, are also driving the growth in the companion animal, more people, more affordable or more income is also driving the adoption of pets, and not only the adoption, but also the medicalization rates of animals.

These are probably the biggest macro trends that are affecting our industry. In terms of how we see the evolution of the different animal proteins that will be consumed in the future, definitely we see a significant growth in poultry, significant growth in swine and also in beef and definitely milk, also will be creating growth opportunities.

Maybe in terms of the consumption will be lower the growth rates, but also the value of the animals will be much higher in cattle than in poultry. Another driver of our growth that we see in terms of animal proteins is the importance of fish in the diets of consumers around the world, not only on wild fish, but also more and more on the consumption of farm fish, that already represents more than 50% of the total consumption of fish, and fish is already the largest protein – animal protein in the world.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. Thank you. Can I ask you a little bit more about your cattle business, how do prices look right now, and then any downside to your expectations for Brazil and is Venezuela still a meaningful market for you? And then, I also wanted to ask you about dairy prices. Yeah.

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

So, let me start with the easiest answer about Venezuela.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay.

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

We decided to exit Venezuela activity business back in 2015, if I remember well. So, we decided that the economic conditions were not attractive. And not only the economic conditions, [indiscernible] (00:03:29) not possible to get money back out of the country, and even selling it to Venezuela, we're not getting our money back. So, we decided there to stop all activity. And we have a minor activity, just shipping when it's cash on return. So, it's a – we ship and they pay in advance, and we sell.

So, for the rest of the market Brazil, and Brazil remain a very important market for us and we have been investing significantly, expanding our presence in Brazil, mainly in commercial. And we saw at the beginning of the year some challenge because of some corruption in terms of the beef and also some issues in the quality of the beef that affected temporary exportations. Reports are indicating that all these issues are behind and they expect the second half of the year Brazil also showing a positive growth in terms of exportations.

So, in terms of general cattle, cattle remain an important part of our business. Today, we have about 42% companion animal and 58% livestock. And in livestock, cattle is the largest species. And one of the things that we always mention is that, even if all the species are important, so one of the strengths of this is the diversity of our portfolio, and we know that we need to manage cycles. Cycles in where the price of the beef maybe is lower, but then the price of pork is higher. And in some cases also, we need to manage that. The prices in China are low or declining, but the prices in the U.S. are growing. So, the diversity in the geographies really helping us to be a predictable company and also generate sustainable growth.

You asked about prices. The prices of meat are, in general, beef in general, are positive and also the price of milk now it's also helping producers also to generate profit. The first half of the year, especially in Europe, they had some challenge in terms of the price of the milk, this is now showing recovery and we don't see any type of significant challenge in terms of prices, it can depend also in which part of the chain are you operating. Now, the [ph] packer (00:06:26) industry is making the highest profitability, while the feedlots are not the most positive time for them, but this will change. So, there are cycles that we have been managing in the past and we'll continue managing in the future.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. One of the questions I've got recently is the hurricanes. And if you see any impact to both your livestock or companion animal business as a result and if they're material at all to the company?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

We have seen some impact in Texas and Florida in – mainly in companion animal, but these impacts, even if they are very negative for some of our customers, we have been helping these customers with some products and some special conditions for recovering their business. This is not material to the total overall revenues of the company or profitability of the company.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. And then, can you talk about Apoquel, sarolaner and Cytoint today? Where are the sales, where could they go and why and what do you think about opportunities outside the U.S. for these products?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

Well, in the second quarter, we reported there a combination of Apoquel and Cytoint. For the first time they exceeded \$100 million. And we also mentioned that we expect the combination of these two products generating \$400 million to \$500 million in terms of peak sales. Sarolaner also is doing very well, it has been introduced in most of the markets. And, I think, we are confident that sarolaner also will generate or will achieve blockbuster status, which means that more than \$100 million in terms of revenues.

And we are also using Simparica, which is the name of the product containing sarolaner. We also expect to use this as a platform to develop more products combining sarolaner with all the other active ingredients that will protect against ticks and fleas, which are external parasiticides, and also other ingredients that will protect against heartworm, which is internal parasiticide.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. So, I guess, I can ask you about the triple combo product and who you compete with in that market and when do you think you're going to come to market with that and how big do you think that will be? Is that going to be as big as Apoquel or something in that range?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

Well, the market of parasiticide, it's the largest in the animal health industry. If I remember well, it's a parasiticide market in companion animal is about \$6 billion, now we have seen that has been shift from tropical parasiticides to oral parasiticides. And then, we are competing with other companies, with these new classes of oral parasiticides. Some of these companies they are also developing combo products, but we think that because we have the presence and we also have the portfolio, we'll gain the share that it's in line with our size and our expectations also in the parasitic business or segment.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

So, you already started talking a little bit about PHARMAQ, so just curious if you could talk more about that business, how big is it today, what are your key drugs in the markets that you sell into?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

Well, this business, at the end of 2016, it was a little bit less than \$100 million, and we expect that this business will be growing fast, because, as I said, the consumption of fish is growing very fast in the world.

Today, most of the revenues are generated in salmon. And in salmon, there are two countries which are the main producers of salmon in the world, which is Norway and Chile, and additionally, Canada and also UK, they're also producing salmon. We have seen that there are some other markets which are highly interested also in developing the salmon industry, including China. And China is already the largest producer of farm fish. They're using not – they are producing not salmon, but other freshwater fish, which also represent a good opportunity.

We expect that there will be also a movement from protecting animals and using antibiotics, which is the case of many of the producers for fresh fish into vaccination. And with the acquisition of PHARMAQ, we acquired the

number one company in terms of vaccines, I mean, very successfully in salmon, they have been also very successful in vaccine for Mediterranean fish, and now we are working also in developing vaccine for Tilapia, Pangasius and other species.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. And where do you think sales could go for this franchise and how are the margins compared to your corporate average for PHARMAQ?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

We mentioned that we expect that in 2017 to generate \$125 million in revenues. We had some temporary challenge in Chile, that will probably have an impact on this \$125 million, so we'll be most probably below this, but the long-term projections are that this segment will continue faster than the average of the animal health industry, which is about 6%, so we have the expectation that this segment will continue growing faster than that.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. And maybe just one more question on PHARMAQ. With respect to the other species, especially you talked about one of them, Tilapia, and you mentioned something else, how big are those opportunities relative to salmon?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

I think, salmon definitely will be a fish that will be more expensive and more valuable, but definitely we see a huge opportunity in other species, especially if they move to a more consolidation of farm fish production. And, definitely, they move into the use of vaccines rather than antibiotics. And we know that in countries like China, that I mentioned, is the largest producer of farm fish, the government is highly interested in improving the quality of the production and also the safety of the food. And, with that, we should expect that also in the future these species will be very important.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. Can we talk a little bit about your Nexvet opportunity, the pipeline there, and then where these products are in development?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

So, Nexvet, it's an acquisition that we made at the end of 2016, or beginning of this year, sorry, this year, I am correcting the time, so it was in 2017, that we made the acquisition of Nexvet. And with Nexvet, we are acquiring a company with a very interesting pipeline, R&D pipeline of monoclonal antibodies with very specific target in terms of pain for dogs and cats.

Definitely, we see the opportunity of developing monoclonal antibodies for pain in dogs as an alternative of current therapies, but equally important will be to bring to the market monoclonal antibody for pain in cats. Today, there is an unmet need, a significantly unmet need, how to manage pain in cats. Current therapies, including

NSAID, is not meeting the needs of the market and definitely it's difficult to convince a cat to swallow a pill, but an injectable formulation that will be safe and with good efficacy will represent a significant opportunity in terms of revenues and profits.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. Can we talk about your cash flow generation, which has been pretty robust, and do you expect this to improve even more over time and why, if you do?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

Well, we – definitely, most of the investments are one-time investments that we made in terms of creating the infrastructure of Zoetis and also investing in new systems. All this is behind us. So, we also concluded all the one-time costs of our operational efficiency program that we started in 2015, this is also behind us.

We expect that in 2017 we'll be doubling the cash compared to 2016, and this is something that this company will be generating a significant level of cash. And we define that the priorities in terms of capital allocation will be investing in the business, investing in R&D, in the commercial in manufacturing has been showing a significant payback. The second priority in terms of capital allocation will be M&A. And then, in absence of M&A opportunities, we will return our – the excess cash to our shareholders through dividends or buying shares back.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. Thank you. And then, in terms of the M&A deals, are you still just interested in tuck-in deals or would larger deals interest you if they made strategic sense?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

Well, we are interested in any deal that we can justify in terms of a strategic fit and value creation. But we are also realistic and we know that a large deal in our core business will be very difficult to pass all the scrutiny of regulators in terms of antitrust. We'll continue assessing, but we wanted to make sure that we also find alternatives to these deals with smaller opportunities or go into complementary spaces, spaces in where we don't have the same market share, but at the same time, we can leverage our current infrastructure, our presence in the market and our relationship with customers, and then, offering a much more complete set of products and services to our customers and becoming heavily more relevant to our customers.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. In the past you've talked about diagnostics being one area of focus and now that you have the [ph] Nexvet (00:17:58) on top of your Cytopoint product, you have monoclonal antibodies. Are those areas that you have interest in with respect to tuck-in deals or M&A, or are there other unmet areas in your portfolio that you want to fill?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

We think that, now with Cytopoint, Nexvet and also the expertise we have developed internally in terms of monoclonal antibodies, we are second to none in terms of expertise and capabilities of maximizing this therapeutic area or this technology.

In diagnostics, we acquired a company in Denmark that has a very good platform in terms of technologies for diagnostics. But, we think that the diagnostics – it's very complimentary to the activity that we do with our customers in companion animal and livestock, and definitely we'll continue assessing that, how we can really continue growing this space through internal investment or external opportunities.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

You've talked about 200 basis points of gross margin improvement through 2020, and I'm wondering how we should think about that, where does that come from and is it something that can be gradual or will it happen by 2020, I mean, what's the progression?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

I think, it's part of our plant network strategy that we announced back in 2014, and we said that there were some actions that we're taking, but there are some other actions that will take longer. And we defined that from 2017 to 2020 we'll be generating this 200 basis point of cost improvement. Definitely it will be gradual, but we see that since some of these improvements are related to product transfer, and also some consolidation of manufacturing, it will be more at the end of the period that – at the beginning of the period that would be 2018.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

So we've got about 10 minutes left. I wanted to open up questions to the audience, if anybody has anything. Oh! Sorry, five minutes.

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

5 minutes. All right. Then fewer questions.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Anything? Okay.

Q

[Question Inaudible]

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

I cannot hear you.

Q

Sorry. Just, you talked about pain management in companion animals earlier on.

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

Yes.

A

Q

[Technical Difficulty] (00:20:33-00:20:38) Are there opportunities there for you in that?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

I think that also pain in livestock, especially in cattle, I think, it's an area of opportunity. There are some products that are used to treat pain, but I agree that this can be represented also an unmet need, an opportunity developing some products that will be managing pain in livestock.

A

Q

There have been some issues on manufacturing throughout the pharmaceutical world in [ph] companion animal health (00:21:12), have you been affected by that? I mean, is there [Technical Difficulty] (00:21:17-00:21:23).

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

Well, we had some challenges with manufacturing of Apoquel, but this is also behind us. So, definitely the revenues or the demand of the product exceeded all expectations, but we have been managing that now is something that we have enough capacity to meet or exceed any demand in the world. We know that some companies, they have been facing some challenge in terms of manufacturing. We have in our opinion high standards in terms of quality, which are not having a negative impact in cost, and we have been inspected by many regulations around the world, FDA, USDA, EMA, also the Brazilian and also the Chinese, and so far, I think, we have been always having very good results of this audits and we'll continue working in terms of ensuring that the quality of manufacturing, the processes are in line with all regulators and will be minimizing the risk of any manufacturing disruption.

A

Q

Louise Chen

Analyst, Cantor Fitzgerald Securities

I have more questions for you. So, can I ask you about the diminished use of antibiotics and if that's affected your business or continues to affect your business? And then how does that differ within the U.S. versus outside the U.S., and has there been any impact of the Veterinary Feed Directive on your business?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

The U.S. has been focused on two areas. One is to eliminate the indication of growth promotion on antibiotics in livestock, and we have been working with the authorities to eliminate any product with an indication for growth, and antibiotics, which are important for human health. If the antibiotic is not [ph] used in (00:23:43) human health, then still we can stay in the market. This had probably not a significant impact because also we had alternative in our portfolio to replace these antibiotics with other antibiotics.

The difference has been the Veterinary Feed Directive that we expected a temporary impact at the beginning of the implementation because now for the use of any antibiotic in feed and also injectable, you need that intervention of veterinarian. And we expect that that is more of a customer without a veterinarian in their operations, they will have some temporary adjustment on how to manage the new protocols.

This temporary adjustment has been longer than expected, and we'll provide an update on the total impact for Zoetis in 2017 at the time of our earnings call. But, again, so it's something that even if it's having an impact, the strength of Zoetis, as I mentioned, is the diversity of our portfolio, and we can manage this type of impact in our business because of the implementation of Veterinary Feed Directive, also some actions taken in Europe in terms of reducing the use of medically-important antibiotics, because we have probably the largest portfolio in the animal health industry, the most diversified in terms of species, geographies and therapeutic areas, and even with this type of headwinds, we are consistently delivering our objectives. And this is something that has happened in the past and I'm convinced that will continue to happen in the future.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. Thank you. I want to ask actually about the generic competition for animal health drugs. How does this compare to what we see in human health? Would this change over time? And then, has there been generic competition for Rimadyl and Clavamox, and how has that shaped up relative to what you thought it would shape out to be?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

So, when we see a product in human health losing exclusivity, it's probably having an impact of 90% in terms of price or in volume. This is not happening in our industry. Definitely, we have generic impact, but the generic impact it's maybe reaching 20% to 40% impact over a period of years. And this has been the case of Rimadyl or Clavamox. Definitely, we have an impact because of the introduction of generic, but still Rimadyl after its 10 years of no exclusivity still is a product that is a significant part of our portfolio.

And we – because of there is life after losing exclusivity, we have the opportunity to continue investing in these products in terms of new formulations, combination of products and geographical expansion, which is helping us to mitigate the impact of generic penetration. An example of this formulation is that, now for Clavamox, we just introduced in the U.S. market a chewable formulation, and we expect that this chewable formulation will help us to maintain the share of Clavamox. I'm not saying that the impact that generic will not exist, definitely we'll see the impact, but offering a differentiation into the market also will help us to minimize the impact.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. Last question here, we've got two minutes left. So you have a large pipeline of drugs, what do you think are some key unmet needs in animal health and how is Zoetis addressing these?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

Well, I mentioned that, in cat, it's an unmet need in terms of pain, and we bringing a monoclonal antibody for pain in cats will be responding to a need in the market. We also think that specialty care in companion animal represent a good opportunity. [ph] Renal (00:28:24) and some other areas will be also an opportunity to continue generating growth in companion animal.

In livestock, the biggest opportunity is how to replace technologies that today are challenged by regulators or consumers talking about antibiotics, beta-agonists hormones with new technologies that will help producers to meet their productivity targets. And I'm talking about new classes of antibiotics that will be targeting animals without creating resistance systems in human or genetic work that will help to increase feed efficiencies, fertility and some other targets that will be equally important, or feed efficiencies through new classes of products that will maintain the productivity that is needed to produce the quantities of proteins what are needed to [ph] feed (00:29:30) the population at also – at affordable price.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Q

Okay. I think we're out of time here. Thank you for hosting the presentation with us. So Zoetis is doing one-on-one meetings for the rest of the afternoon, if anybody has any interest.

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

Thank you, Louise.

Louise Chen

Analyst, Cantor Fitzgerald Securities

Thank you.

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