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# Zoetis, Inc. (ZTS)

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## MANAGEMENT DISCUSSION SECTION

Chris Schott

*Analyst, JPMorgan Securities LLC*

Good morning, everybody. I'm Chris Schott from JPMorgan. It's my pleasure to be introducing Zoetis this morning. From Zoetis, we have the company's CEO, Juan Ramón Alaix. With that, I'll turn it over to Juan Ramón.

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Juan Ramón Alaix

*Chief Executive Officer & Director, Zoetis, Inc.*

Thank you, Chris and good morning. It's always good to be here again and have the opportunity to discuss about the unique aspects of our industry animal health and Zoetis. But, before I begin, let me remind you that today I will be making some forward-looking statements, also a number of non-GAAP measures. You can read the details of our risk, uncertainties also the adjustment from GAAP to non-GAAP in our SEC filings.

So, let's – this will be the agenda I would like to cover today. So I like to discuss about the growth drivers, the trends of the animal health industry. Also to highlight the strengths of Zoetis that has been enabling us to deliver consistent results in our five years as a public company. And then finally also I will discuss about details of our investments that will support our future growth and also will create value to our shareholders.

So, let's start with some comments about our industry. It's an industry with no third-party payers, with limited generic competition and also high-level of productivity in our R&D investment, which makes our industry very predictable and also showing very steady growth. Overall, it's an industry of \$150 billion (sic) [\$150 billion], which include products and services that we deliver to the veterinarians, producers, ranchers, pet owners. And it's an industry that touches most of the people in this room. Either you have a dog, cat, horse, or you are eating any animal proteins, meat, eggs, dairy products, it is part of the activity that we do in the animal health industry.

I work in this industry since 2006 and also been leading Zoetis since then. And I understand I appreciate the trends, the growth, the dynamics of this industry that really showing very steady growth in the last years. The industry added \$5 billion in revenues from \$26 billion (sic) [\$26 billion] in 2013 to \$31 billion (sic) [\$31 billion] in 2017.

Another important aspect of our industry is the diversity in terms of species, geographies, which is also providing a model, which is very resilient to economic crisis, to regulatory changes and also to consumer preferences. This industry has been growing by 5% to 6% in the last years. We have been exceeding this growth as Zoetis in the same period. We grew by 7.5% from 2013 to 2017 as a compound annual growth and also we expect that (sic)

[this industry], we continue growing in a steady way in the next years. We expect that we'll be reaching \$41 billion by 2022.

So now let me discuss that briefly on what are the drivers of this growth in our industry. First, so the number of animals, so number of animals both in livestock and companion animal continue growing. The second aspect of the growth is related to medicalization rate in pets also growing. And the third is the consumption of animal proteins which is growing based on the population growth. At the same time, we see that this growth in the amount of animal proteins is facing the challenge of limited resources. So it's very important for producers that that they get the technology, the products that will continue increasing productivity. And it's where companies like Zoetis can bring this type of products and solutions to our customers.

In livestock, we observe and address trends, which are very important. The first one as I said is the continuous increasing in the consumption of animal proteins. The second is that, some of the existing technologies now has been challenged by regulators, retailers and also consumers. An example of this challenge is the discussion on antibiotics and we are participating in this discussion, we are supporting the rationale or judicious use of antibiotics and also we are supporting that antibiotics should be used under the supervision of a veterinarian.

At the same time, we need to understand that there is no alternative to antibiotics when an animal is sick, but we are working in developing solutions to protect or to prevent animals against infections. And also we have a portfolio that in some cases is also meeting the needs of producers to address consumer demand of producing without antibiotics.

We think that the way to address the trends, dynamics in livestock is to have a much more comprehensive approach on the solutions, including from prediction, moving to prevention, detection and also finally treatment. In companion animal, we also are addressing the changes in this sector. We are convinced that veterinarians will continue playing a significant role in terms of influencing the decisions of healthcare and Zoetis will be continue supporting veterinarians as a key driver of healthcare in companion animal.

We also think that animals, pets are becoming more and more part of our families. And it's also driving two aspects in our industry. First, I think it's moving to even more use of specialty products not just vaccination, but also products like APOQUEL which are treating diseases in allergy or dermatology. And we're convinced that it will be a significant expansion of companion animal through the implementation of new solutions in terms of a specialty care.

We also see that pet owners are more and more interested in understanding how to take care of animals. They can have access through social media. They are also much more exposed to DTC. And we are also using these type of approaches to customers, not to bypass veterinarians, but to ensure that we are connecting veterinarians to pet owners and we increase the level of care in animal health.

So, how we respond to the needs and the trends of our customers? The way that we manage innovation is really having a full understanding of what I describe from the detection, restriction, also treatment, also including the prediction of all the different aspects.

And what do I mean by that? So in terms of prediction, you're talking about information which is related to genetic traits, I'm not talking about genetic manipulation, I'm talking about genetic markers that will help farmers and veterinarians to identify individuals that will be responding to certain characteristics. And one example, it's some of the genetic markers that we have in our dairy business, in where we can identify cows, which are responding to higher rates of fertility, welfare or even milk production. And this can help in the [indiscernible] (00:10:01)

individuals that then they will generate the next generation of cows that will be providing higher productivity to our farmers.

In prevention, we have a lot of vaccines in our portfolio, but we are also focused not on delivering or producing the vaccines, but how we deliver these vaccines. And we have in our portfolio devices that are vaccinating eggs before hatch, injecting directly into the embryo and protecting the embryo before becoming a chicken.

It's a high level of [ph] sophistication (00:10:47) that is also improving the efficiencies and the productivity of poultry farmers. We also have similar devices also in the fish in where we have acquired a company that also will be providing vaccination – automatic vaccination to fish and this have the opportunity to expand the vaccination not only in salmon where we have the majority of our revenues today, but also to some other species that will benefit of this type of devices.

And we also know that it's important to detect diseases and by detecting diseases, we can apply the right protocols in terms of vaccination or in terms of treatment. And we have now entered into the diagnostic business with the acquisition that we made in 2011, focus on point of care, rapid test, but also with the acquisition that we made in – at the end of 2016 when we acquired Scandinavian Micro Biodevices, which is adding our portfolio that will be covered in also equipment. That is something that we will be progressing in introducing these products into the market.

So, definitely, this is something that we have been able with all these efforts to create a very strong leadership position, a leadership position that you can see, it's applicable to different dimensions, strong position in terms of our geographies, strong position in terms of species and also in terms of therapeutic areas.

And this strong position is based on a very strong portfolio. We have a portfolio, which – it's covering almost all the needs of our customers, in all different species, in all different therapeutic areas. It's a portfolio that in many cases, it's including best-in-class products for prevention and treatment. And also it's a portfolio that has a very specific characteristics of – in terms of durability. Our top 24 products at the end of [ph] 2016 (00:13:23) has been in the market for an average years of 30, so you can see that the durability of our portfolio is very strong and this is the result of applying innovation not only to new products, but also applying lifecycle innovation to our existing portfolio. This also demonstration that generic competition in our industry is much more limited than in human health.

We also have introduced in the last years, significant blockbusters like APOQUEL, CYTOPOINT and Simparica. So we are combining a very durable portfolio with the introduction of innovation, which is also responding to the specific needs of our customers. And we are also supporting our portfolio with our business model that has been developed over time and now it's proving extremely effective, which is the combination of three interconnected capabilities: our direct access to customers through our own field force, the quality of innovation, and the quality of manufacturing.

Combining these three together, is what it's making Zoetis, the leader of this industry. And it's also a leadership, which is demonstrated by results. We have been consistent in delivering our commitments to the market. In the last five years, we have been growing very consistently and very consistently faster than the market. And we have been growing not only in terms of revenues, we have been improving significantly our margins.

You see that we move our EBIT margin in 2013 from 24% to 32% at the end of [ph] 2016 (00:15:34) and we are projecting continued growth in our EBIT margins in 2017. As we completed also our efficiency program that we announced in 2015, we have been also able to generate significant free cash flow. And we expect at the end of

2017 almost doubling the free cash flow compared to 2016. So, another example of not only leading in terms of revenues, but also leading in terms of profitability and cash generation in our industry.

As we have been able to generate these type of cash, we can also have the opportunity to address different capital allocation opportunities. First, we'll continue investing in our company, because we have been showing that investing in commercial, R&D, manufacturing has been showing very strong payback. We'll be also investing in acquisitions. We think that we can complement our organic growth with external opportunities and we return the excess cash to our shareholders.

In 2017, when – we have not yet reported our final numbers, we expect that we'll be investing \$375 million to \$385 million in R&D. We have been allocating resources for capital projects of an amount of \$215 million. We made a small acquisition, but very strategic one of Nexvet that cost us \$82 million. And finally also we returned cash to our shareholders

We paid dividends of \$205 million. We announced in December that we are increasing our dividend by 20%. And we also continue with the program that we approved in 2016 of \$1.5 billion of buying shares back. And we are consistently applying around \$500 million share repurchase per year, \$500 million. So you see that we are – continue having a prudent use of our capital. And it is something that we plan to continue doing in the future.

With all the cash that we are generating also, I discuss about the priorities in terms of investing internally. We want to continue ensuring that we allocate resources to maximize the potential of key products like APOQUEL, Simparica, CYTOPOINT. We are combining promotional activities with also DTC campaigns. And the other area in where we'll be also investing is developing new capabilities to support our future growth in diagnostics and also in genetics. So we plan also to expand capabilities in commercial to support these businesses.

We also continue investing in R&D in programs like monoclonal antibodies. We are convinced that monoclonal antibodies will play a significant role. We have already one product CYTOPOINT in this category. We acquired Nexvet that is also providing some additional programs, some additional monoclonal antibodies for pain and other indications. And we'll continue investing also in combination of parasiticides to have much broader coverage of internal and external. And we'll continue investing in vaccination.

Vaccines will play a key role in the future, and we want really to continue lead in this space. And finally, we are investing also in manufacturing. In manufacturing, we decided to invest in a new vaccine plant in China that will be start – breaking ground in the spring of 2018 and will be operational in a couple of years.

This will be a manufacturing plant to produce vaccines for swine, cattle and also fish. We decided also to invest in plants for producing active pharmaceutical ingredient, and being less dependent on third parties, it's a plant that we acquired in Ireland.

We're also expanding our capabilities and capacity in Michigan, in Kalamazoo, where we have also manufacturing plant, and also in Charles City, Iowa, to ensure that we are incorporating new technologies for the production of vaccines.

In 2014, when we had our first investor meeting, we defined the value proposition to shareholders, and we have been very consistent delivering our proposition of growing in line or faster than the market in terms of revenues, also growing adjusted net income faster than revenues. Also we have been able to deliver this objective, and also targeting investment that will create value to Zoetis. And finally, returning excess capital to our shareholders. We are very confident that this value proposition also will be delivered in the next coming years.

Let me finalize with some takeaway comments. First, Zoetis is the world leader in a market that is very attractive, because it's very predictable, it's showing growth, it's probably not having too many negative surprises, and is very resilient.

Two, as I said economic cycles, regulatory changes or even consumer preferences. We have a model that has been proven very effective; it's a model of interconnecting commercial R&D, and also manufacturing. And we have the characteristics, global presence to continue leading this space.

And when I say, leading this space, I'm not talking about revenues; I'm talking about bringing innovation that we'll be generating the next generation of products into the market. And finally, something that all Zoetis colleagues are very proud, we have been very consistent in delivering our financial commitments. And I can tell you that, this is an area that will be always focused and committed to continue delivering our valuable position to all our shareholders.

Thank you very much.

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