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Zoetis, Inc. (ZTS)

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CORPORATE PARTICIPANTS

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MANAGEMENT DISCUSSION SECTION

Chris Schott
Analyst, JPMorgan Securities LLC

Great. So I think, we're ready to kick-off the Zoetis' breakout session. Maybe, I'll kick-off with a few questions, then we'll open up to the audience to go from there.

QUESTION AND ANSWER SECTION

Chris Schott
Analyst, JPMorgan Securities LLC

Q

Maybe the first question I have is, if I think about the derm franchise, it seems like that's been a huge source of upside relative to everyone's expectations. As we kind of think about 2018, can you just talk a little bit about where we are in the ramp of these core products, both U.S., ex-U.S. and what the organization is focused on to continue to maximize the value of these products?

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

A

So let me start with the U.S., in the U.S., we have both products, APOQUEL and CYTOPOINT, that has been – APOQUEL last several years, and CYTOPOINT, it's probably a little bit more than a year now. And the two products combined, we have reached patient share of 60%. So we still see opportunities to continue growing in this dermatology space, and where we are also expanding the market with the investment in direct-to-consumer. So we want really to increase the awareness of dermatology issues, and bring more pet owners to the clinics, and we know that dogs who are leaving the clinic, also will be on APOQUEL or CYTOPOINT.

In international markets, we have APOQUEL in almost everywhere except China. In China, it's taking longer, but we also expect that China will be also introducing this product in the future. And CYTOPOINT in the European market has been introduced to all veterinarians from September. We have also some early programs experience, but the full launch was in September.

So we expect that, in international markets, both our products APOQUEL and CYTOPOINT, we still have much more ground for growing, and this will represent a gain in 2018, a good opportunity to generate revenue growth. We expect definitely that the revenue growth rate will be lower than in 2017, but still we'll be adding some additional growth to our company.

Chris Schott

Analyst, JPMorgan Securities LLC

Q

And can I just ask, in terms of the international markets, you mentioned the 60% share you have in the U.S. Do you see the ability to get that type of share in the international markets or is it more challenging dynamics in some of those settings?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

Well, I think it's [ph] depending (00:02:37) we are talking about developed markets or developing markets, and maybe the definition of developed and developing is not exactly the same that can be used in some other sectors. In companion animal, maybe it's much more in line with definition of developed or developing.

We expect that, while the opportunity to reach this patient share in developed markets should be similar than in the U.S., although we also expect that it will take longer. So the adoption of APOQUEL in the U.S. has been much faster than international markets, and we expect also that in the end, we'll be reaching similar use, but taking longer.

And in developing markets, it's different, because we're also pricing the product almost at the same level in all markets. And maybe the affordability of some of these markets is different, and then reaching the same level of patient share would be more complicated.

Chris Schott

Analyst, JPMorgan Securities LLC

Q

Just a broader question on R&D, and kind of how you think about the portfolio evolving? You brought a lot of innovation to the derm part of the Companion market. What are the other areas that you're excited about in terms of development that could – we could see a similar level of innovation from Zoetis?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

Well, we are very excited about the opportunities that monoclonal antibodies would represent to Zoetis, not only to Zoetis, also to the animal health industry. We have seen the adoption of this technology in a human health very fast. We have already one significant product, one, monoclonal antibody, CYTOPOINT for dermatology.

We acquired Nexvet, that it was a company focused on monoclonal antibodies for pain in both dogs and cats. So, we see a significant opportunity to bring into the market, in the case of cats unmet need, because there is no product in these species that it's – well, being used, so bringing an injectable formulation that [ph] it will be once monthly (00:04:54) this will be a great opportunity to develop this market.

But also, we think that in the dog, in where we have many products available mainly NSAID, still some level of dissatisfaction because of the safety profile of some of these products. So monoclonal antibodies, they have the advantage of being extremely safer. And we think that they can capture part of the market, which is today more than \$400 million in dogs for pain.

But we also think that, monoclonal antibodies, we'll be expanding the use not only to these two areas that I described, but to renal oncology and many other areas including maybe a livestock opportunities, not only companion animal.

We're also very excited about the opportunity of continue developing sarolaner, which is the active ingredient of Simparica, the oral parasiticides for ticks and fleas, also expanding the coverage, also to internal by combining some other agents, and we are working on combining sarolaner with another two agents that will have full protection of internal and external parasiticides. Another idea that we think it's extremely important it's continue investing in vaccines, and not only investing in general. So the objective of Zoetis is to ensure that we are the first to know new emerging diseases, and the first to bring a solution to the market.

We have been showing that we can do that with several examples in 2017 and 2016, and this is the focus that we have. We want to ensure that we are best-in-class vaccine R&D facilities, expertise, capabilities and we also translated the knowledge that we have into the market through our R&D organization, and then, the R&D organization is very well connected with manufacturing, because this is also helping us to speed the process of developing and introducing the product into the market.

We have many other programs in R&D that are equally exciting. I think, definitely opportunities to replace antibiotics, opportunities to increase also productivity, but also we approach R&D now with a much more comprehensive view, not only just animal health, but what I describe today as prediction, genetics, detection, diagnostics, prevention vaccination, and also treatment, when the animal [ph] finally gets sick (00:07:42).

Chris Schott

Analyst, JPMorgan Securities LLC

Q

A couple more, and I'll open up to the audience here. Just first, maybe talk about tax opportunity. The company was, within my coverage universe one of the bigger beneficiaries of corporate tax reform, can you provide a little color on that, but I guess your perspective on how you think about the rate over time? How do you think about tax reform as you think about your capital structure and capital deployment priorities?

Glenn David

Chief Financial Officer & Executive Vice President, Zoetis, Inc.

A

Sure. So, in terms of tax reform, so we did issue an 8-K on Monday morning to give a preliminary view of what the impact of tax reform would be for Zoetis. So, from an adjusted effective tax rate perspective, the guidance that we had for 2017 was a tax rate of approximately 29%. With tax reform, we expect to get another 700 basis points to 800 basis points improvement in that rate. So we project for 2018, a tax rate of 21% to 22%, which is a significant benefit.

We do have also a one-time impact related to tax reform, so in Q4 of 2017, we do expect to take a one-time charge outside of adjusted earnings, so one-time GAAP charge not to exceed \$350 million. And that's something that we'll continue to refine, provide additional guidance in February.

So, overall it is definitely a positive impact for us from a cash flow perspective, and does give us more flexibility. It doesn't necessarily change our capital allocation priorities. The priorities remain the same in terms of investing internally first, because we believe we get the greatest return there. Second, priority being business development and M&A, and then third priority being returning excess capital to our shareholders. But with tax reform, with the greater access to cash worldwide, it does give us greater flexibility to execute on those priorities.

Chris Schott

Analyst, JPMorgan Securities LLC

Q

The next question on that, you've highlighted your cash flow is really stepping up this year. Your business is growing, now you get this benefit from tax reform. When I think about those priorities, it seems like your biz dev

has been more tuck-in kind of opportunities to me. Should we think about more capital coming back to shareholders, and that you do seem like you're – if there's a lot more cash than you've had in the past to work with?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

Well, I think it's a – well, first we already communicated that we're increasing our dividend by 20%. So, it's – because we are confident that the company is going to generating the cash, and I think this will be increasing our dividend. We also have a program to buying our share back. But because of the level of cash that we are generating, we think that we can do both. We can invest in the business; we can consider that business as developmental opportunities, at the same time, returning cash to our shareholders. I don't think that these priorities are exclusive, so we can really do all these things at the same time as we have been doing in the past.

Chris Schott

Analyst, JPMorgan Securities LLC

Q

[indiscernible] (00:10:35) any questions from the audience?

Q

[Inaudible] (00:10:37-00:10:54)

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

I think we are also connected. So maybe Glenn will be repeating the question to ensure that the people or the audience – and then I will respond so.

Glenn David

Chief Financial Officer & Executive Vice President, Zoetis, Inc.

A

Yes. So, let me know if I've got your question accurately. But I think the question was around learning from some of the applications that have been done in human health and applying them to animal health and specifically related to CRISPR technology if we see opportunity for that within the animal health area?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

And definitely, we see opportunities of our panel with human health companies, biotech companies or pharma companies without animal health division. It's something now that we have this access. When we were part of Pfizer, we had the conflict of interest of those companies and limitation in terms of these collaborations, and we see that there are technologies that would be applicable to animal health which are being developed by human health, at the same time, we also can bring into the discussion our expertise in animals. And it's important to remember that the clinical phases in human health always start with animals, so that you have experience with animals, we can provide the expertise of the animals and we can really identify drugs that are responding in these early phases and then apply these into our animal health business.

Q

[Inaudible] (00:12:21-00:12:43)

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

Okay.

A

Glenn David

Chief Financial Officer & Executive Vice President, Zoetis, Inc.

So the question was around the success of our atopic dermatitis portfolio and with that success what do we expect competition's reaction to be and when do we expect competition to enter the marketplace?

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Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

I will be surprised that competitors are not doing their work. So we have been showing that this space has a significant potential and they should be working on developing some alternative to our current portfolio. The level of which we lead in animal health is very limited at least for the largest companies which are part of human pharma. They don't have the need of disclosing any type of information about the pipeline, so visibility it's very limited. We know that some small or smaller public companies that has been making comments about monoclonal antibodies that can be applicable to dermatology and they are also considering partnership with other companies or asking for partnership with other companies.

A

If they are at the face of just identifying and then they didn't start developing, it will take several years to develop these products and the reach the market. In any case, we have defined now a very strong profile, in terms of oral, APOQUEL and also injectable CYTOPOINT. And competitors also they have a significant challenge in terms for developing product that will be as effective and as safe as APOQUEL or CYTOPOINT.

So definitely it's something that we expect to happen, but also we have seen that when these competitors are also entering into this space, now it's dominated by one company Zoetis, also they are helping us to expand the market. So I don't see as complete negative to you have even more people promoting products in dermatology and also ensuring that well we are not just treating current population, but also expanding to new patients.

Q

[Inaudible] (00:15:00-00:15:08)

Glenn David

Chief Financial Officer & Executive Vice President, Zoetis, Inc.

Question was around the recent hire we made in the diagnostic space, and what our goals and aspirations are for that business?

A

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

Well, definitely we are committed to diagnostics. We think that it's extremely complementary to our business. And I mentioned today that we wanted to expand our commercial capabilities in diagnostics, it's something that we are planning for 2018. So, we needed to add not selling capabilities, but technical capabilities. And what we added to

A

our team is an expert in diagnostics, a veterinarian, which is an opinion leader in diagnostics, and we think that this will help us to really support our objectives to build this franchise.

Chris Schott

Analyst, JPMorgan Securities LLC

Q

Yes, Juan. Just the U.S. livestock market, can you talk a little bit about as we go into 2018 some of the dynamics you're seeing playing out there and should we think about inflection point in growth given some of the challenges you faced in 2017?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

So in 2017, when we reported the third quarter, we showed a decline in livestock in the U.S. But we also mentioned in the third quarter that we expect a recovery in the fourth quarter, and we think that this is something that is already happening. We see a much better momentum in livestock in the U.S. There are different factors that make us optimistic about livestock. One is that the impact of the Veterinary Feed Directive will be now over in 2018. I think has been a rebase. So, in terms of growth, we'll have not a negative impact in 2018.

We also saw in 2018 that the winter conditions in the first part of the year were mild and also this also drove animals moving to the feed lot heavier with lower risk profile and lower need of protection and also treatment. We have seen in the second part of the year, mainly in the fourth quarter in the U.S. that this is changing, animals are moving to their feed lot lighter, and also the winter you have seen it has been quite extreme those days. So all these elements probably can be negative for some people and possibly for the animal health industry. We also expect that our swine business that has been facing some challenge in the U.S. also will be recovering in 2018 because of the interaction of new products, but even if we are in some cases very focused on livestock U.S. one of the advantages of Zoetis is the diversification of our business in terms of geographies.

And we know that there are fundamentals which are positive in our industry despite of weather conditions or animals lighter or heavier which is the consumption of animal products. And we saw in 2017 that that international markets in livestock were performing extremely well. And in the end, so we are really managing a global business and we know that there will be cycles. But these cycles will be in most of the cases compensated the following year or within the year because of our diversity.

Chris Schott

Analyst, JPMorgan Securities LLC

Q

Just to ask another one just on gross margins. I know there was some debate this year with your gross margin progression I think there was numbers low at the beginning of year, [indiscernible] (00:19:13) questions how do they step up, we clearly have seen that. Just tell us – can you talk a little bit about just how we bridge first half versus second half, what drove that? And then as we think out to next year, how good of a proxy is the second half gross margin performance in 2017 as we think about future margins for the company?

Glenn David

Chief Financial Officer & Executive Vice President, Zoetis, Inc.

A

Yeah. So, when you look at gross margins in 2017 there definitely was a disparity between the first half and the second half. So the first half, our gross margin was approximately – or our cost of goods sold as a percent of sales was approximately 35%. Our guidance for the full year is approximately 33%. So definitely implying a significant improvement in the second half, which we began to see in the third quarter. The key driver for the first half being at 35% was recognized a disproportionate amount of the cost of prior year inventory, and working

through that inventory in the first half of the year. So, what we're seeing in the second half of 2017, more reflects the underlying cost structure of the products moving forward.

So the second half is a better reflection of what we'd be moving forward into 2018. Now that being said, there are a number of factors that impact cost of goods in terms of mix and other components that would be baked in and when we provide guidance in February for 2018, we'll provide an update on what we expect that to be in terms of overall gross margin for 2018.

Chris Schott

Analyst, JPMorgan Securities LLC

Q

[indiscernible] (00:20:29) working capital of the company I think has always – working capital of the company has always seemingly been running a bit higher than...

Glenn David

Chief Financial Officer & Executive Vice President, Zoetis, Inc.

A

Yeah.

Chris Schott

Analyst, JPMorgan Securities LLC

Q

...another [ph] good (00:20:39) great comps, but there's [indiscernible] (00:20:42). Talk about – is there an opportunity on working capital we should be thinking about as we kind of look out the next few years?

Glenn David

Chief Financial Officer & Executive Vice President, Zoetis, Inc.

A

We think there's definitely an opportunity on working capital. When you look at our balance sheet, the particular area that stands out is our inventory levels. So if you look at the end of last year, our inventory stood at over a 11 months on hand of inventory, which when you look at the comps in the industry definitely is high. The comps in the industry will tell you that the range should be anywhere from 7 to 9 months, and that's what we're targeting over the next number of years. And I think you started to see progress on that, if you start to review our balance sheet in Q3 for example, you'll see that we started to make some pretty significant improvements in our months on hand of inventory which we expect to continue into 2018.

Chris Schott

Analyst, JPMorgan Securities LLC

Q

And there's a final question out there [indiscernible] (00:21:27)

Q

Can you just talk a little bit just on business development priorities and what are – you know, if you look at your portfolio as it exists today, what are the – what are you most focused on in terms of continue to augment what you've built already?

Juan Ramón Alaix

Chief Executive Officer & Director, Zoetis, Inc.

A

So, as I said during my presentation, we have a portfolio, which is very strong, we have very few gaps in our portfolio. And – but still we think that there can be opportunities in some of geographies in where we have lower

market share. We have in countries like the U.S. 26% market share, but the average is 16%, so you can understand that there are some markets where we see opportunities to enhance our presence and also not creating anti-trust issues. So this is mostly related to our core business. We'll be continuing also assessing opportunities in our core business in terms of new technology that will be supporting our internal R&D efforts.

And what we have seen is that there are areas that are very complementary to our business, which are part of our interactions with our customers, are part of the solution that our customers need. And because we don't have the same level of market share, these are areas that are not creating anti-trust concerns. I'm talking about genetics, I'm talking about devices or also talking about diagnostics.

So, we see opportunities that were integrating a much more comprehensive portfolio. Definitely we already are in some of these end markets. But in some cases we can see the opportunity of accelerating the scale that we are targeted. And also have much bigger impact into our operations. We are convinced also that integrating all these different businesses also will help our core business. Because we'll be much more relevant to our customers, we'll be also to justify better the use of vaccines, and also the use of medicines and we'll be providing the productivity, which is needed in farming.

In farming, now – it's – there are a lot of challenge, a lot of technology that has been maybe under scrutiny. We need to find ways of achieving that, the same or higher productivity with some of the alternatives. We think that Zoetis is in a position of managing all this comprehensive solution and bringing that as a single company to our customers.

Chris Schott*Analyst, JPMorgan Securities LLC*

Well, thank you so much for the comments.

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

Thank you.

Glenn David*Chief Financial Officer & Executive Vice President, Zoetis, Inc.*

Thank you.

Chris Schott*Analyst, JPMorgan Securities LLC*

Thanks Glenn.

Glenn David*Chief Financial Officer & Executive Vice President, Zoetis, Inc.*

Thank you, Chris.

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