Corrected Transcript

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# Zoetis, Inc. (ZTS)

Q1 2017 Earnings Call

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# MANAGEMENT DISCUSSION SECTION

**Operator**: Welcome to the First Quarter 2017 Financial Results Conference Call and Webcast for Zoetis. Hosting the call today is Steve Frank, Vice President of Investor Relations for Zoetis.

The presentation materials and additional financial tables are currently posted on the Investor Relations section of Zoetis.com. The presentation slides can be managed by you, the viewer, and will not be forwarded automatically. In addition, a replay of this call will be available approximately two hours after the conclusion of this call via dial-in, or on the Investor Relations section of Zoetis.com. At this time, all participants have been placed in a listen-only mode and the floor will be open for your questions following the presentation. [Operator Instructions]

It is now my pleasure to turn the floor over to Steve Frank. Steve, you may begin.

## Steve Frank

*Head-Investor Relations, Zoetis, Inc.*

Good morning, and welcome to Zoetis First Quarter 2017 Earnings Call. I'm joined today by Juan Ramón Alaix, our Chief Executive Officer; and Glenn David, our Chief Financial Officer.

Before we begin, I'll remind you that the slides presented on this call are available on the Investor Relations section of our website, and that our remarks today will include forward-looking statements. And that actual results could differ materially from those projections. For a list and description of certain factors that could cause results to differ, I refer you to the forward-looking statements in today's press release and our SEC filings, including, but not limited to, our annual report on Form 10-K and our reports on Form 10-Q.

Our remarks today will also include references to certain financial measures which were not prepared in accordance with generally accepted accounting principles for U.S. GAAP, a reconciliation of these non-GAAP financial measures to the most directly comparable U.S. GAAP measures is included in the financial tables that accompany our earnings press release, and in the company's 8-K filings dated today, May 4, 2017. We also cite operational results which exclude the impact of foreign exchange.

With that, I will turn the call over to Juan Ramón.

## Juan Ramón Alaix

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

Thank you, Steve, and good morning, everyone. Before I discuss our first quarter results, I want to share some of our views on the animal health industry. Our industry continues showing steady and predictable growth in the mid-single digits with about 5% to 6% growth for 2017, excluding the impact of foreign exchange.

In 2017, companion animal and poultry are expected to grow faster than the industry average of 5% to 6% while cattle and swine will be growing below those rates.

Companion animal growth will be driven by the increase of oral parasiticides and specialty care products in areas like dermatology, where our portfolio of Apoquel and Cytopoint is driven category growth. We should also see increased consumption of chicken driving growth in poultry. While expecting slower growth, cattle and swine will benefit from positive trends driven by additional head of cattle, higher prices of milk and an increase of global pork production, especially in China.

As I have mentioned many times in the past, the relationship of the animal health industry in terms of species to particular areas and geographies is an important factor in the steady and predictable long term performance. And in this industry, Zoetis stands as the most diversified animal health company and continues delivering revenue growth above the industry average thanks to the strength of our portfolio and business model.

We continue investing in our portfolio with highly productive R&D programs resulting in product launches and lifecycle innovations. In fact, we have continued to expand our canine dermatology portfolio. We've internally discovered and developed our product, Cytopoint. Last week, Cytopoint became the first monoclonal antibody approved in the European Union for veterinary use after having been previously approved in the U.S. in December and in Canada in March.

Cytopoint is the first monoclonal antibody therapy approved to help reduce the clinical signs associated with atopic dermatitis, such as itching in dogs. We are very excited about the early market adoption of this product in the U.S. and the treatment choice it offers our veterinarian customers.

In February, we also announced that the European Commission granted us a full license for Stronghold Plus, a topical parasiticide for cats that combines sarolaner, the active ingredient in Simparica, with selamectin, the active in our current Stronghold and REVOLUTION product lines.

We continue to look at the ways to use sarolaner as a platform for other combinations and in another markets. We also continue to pursue lifecycle innovations that help ensure the availability of our revenue streams from approximately 300 Zoetis product lines.

In the first quarter, we received approval for new indications, formulations and geographic expansion of key livestock brands such as Bovi-Shield and Fostera vaccine families and the Excenel RTU and Excede anti-infective.

We continue to strengthen our portfolio in areas like Diagnostics with new approvals in the U.S. for our WITNESS and SERELISA lines of diagnostic test kits. You can read more about this in our press release.

We also combined our internal investment in R&D with external opportunities in both our core business of medicines and vaccines and the expansion of our portfolio in complementary spaces like diagnostics, genetics and biodevices.

You have heard me speak in the past about acquisitions like PHARMAQ in the fish market and SMB in the diagnostic space, and just a few weeks ago we announced another investment in our core business for treating pain in companion animals.

We announced an agreement to purchase Nexvet Biopharma, which is an innovator in monoclonal antibody therapies for companion animals. This acquisition is expected to strengthen our R&D pipeline in this area and help sustain our category leadership in chronic pain for dogs while expanding the market availability in cats.

Innovations like this are being supported by other investments with additional savings from our operational efficiency programs, and we have included in our guidance. For example, field force expansions in key markets like China and Brazil, direct-to-consumer marketing campaigns for Apoquel and Simparica and capital investment in our manufacturing network to ensure we have the technology, capacity and capability to support our long term revenue growth.

All of these elements are working together to make sure we can capitalize on the opportunities ahead of us to continue growing revenues in line with or faster than the market and growing adjusted net income faster than spending.

In the first quarter of 2017, we continued to see positive results from our diverse portfolio, innovative new companion animal products and a more efficient cost structure. Our revenue grew 6% operationally and excluding the impact of product rationalizations, which will also affect the second quarter results, our growth would have been 8% in the first quarter. We believe this growth is, again, faster than the market.

The main driver of our revenue growth remained companion animal products, which grew 12% operationally, driven largely by sales of Simparica, Apoquel and Cytopoint. And our livestock portfolio grew 3% operationally with increases in swine, cattle and fish being partially offset by a decline in poultry products. Glenn will discuss that more of the market drivers and details in his remarks.

We posted 10% operational growth in adjusted net income, once again faster than the revenue growth. We saw a modest 2% operational growth in operating expenses as we made investments in the promotion and support of new product launches which were partially offset by savings from our operational efficiency initiative. We continue to stay focused on ways to simplify our operations and drive efficiency, including through the ongoing implementation of our supply network strategy.

In March, we announced plans to sell our manufacturing site in Guarulhos, Brazil. We expect to complete that transaction during the second half of 2017. It will be the eighth site that has been either divested or exited as part of the operational efficiency program and supply network strategy. We are pleased with the strong start to the year from a revenue and adjusted earnings perspective. And we are affirming our full-year 2017 guidance.

With that, let me turn things over to Glenn, who will provide more details on our first quarter results. Glenn?

## Glenn David

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

Thank you, Juan Ramon. We performed well again in the first quarter based on our newest companion animal products and strength across many of our international markets; most notably, China, Brazil, Australia, and other emerging markets. Total company revenue grew 6% operationally, including a negative 2% impact from product rationalization. We saw no net impact from foreign exchange in the quarter. However, as our financial tables show, there were some meaningful changes in some individual currencies.

Of that 6% growth, 5% came from companion animal growth in Simparica, Apoquel and Cytopoint. Sales of Simparica were $29 million for the quarter, and our total dermatology sales were $77 million. Additional growth drivers for the quarter were 1% from the introduction of other new products and a 2% impact from price increases. These growth drivers were partially offset by a negative 2% impact from product rationalizations. In terms of the bottom line, we delivered 10% operational growth in adjusted net income and 10% operational growth in adjusted diluted EPS.

As we realize the benefits of our operational efficiency initiative, we have stayed disciplined on expenses to drive more profitable revenue, while making the appropriate investments to grow the value of our business. Juan Ramon spoke about these in terms of commercial and manufacturing investments.

Now let's discuss segment revenues. Our international segment generated operational revenue growth of 9%, while the U.S. grew 4%. In the international segment, product rationalization had a negative 4% impact on growth. China had an exceptionally strong quarter, growing 47% operationally. This growth was broad based, with contributions from both swine and companion animal, with much of the growth coming from vaccines.

In swine, we continue to see strong market conditions with high pork prices for customers as well as greater adoption of animal health products that can help drive more efficient and safe protein production.

In companion animal in China, our field force is capitalizing on a growing pet population and increases in medicalization rates for pets. Brazil was also a strong contributor in the quarter, growing 15% operationally, with our price increases driving growth across our portfolio there.

Significant growth in livestock benefited from strong market conditions for beef producers. And new companion animal products drove higher sales, with Simparic, as it's known in Brazil, getting off to a strong start from its launch in the fourth quarter. Our growth in both China and Brazil was aided by field force expansions in these markets which we have discussed before.

Mexico made a significant contribution this quarter as well, with 10% operational growth. And our other emerging markets category grew 14%, despite a significant impact from our product rationalization.

Shifting to developed markets, Australia grew 10%, drawing on performance in several key brands in Cattle, Sheep and Companion Animals as well as price increases and growth in Simparica and Apoquel.

Italy, Spain and Japan also contributed to growth in the quarter while France declined 15%, primarily due to the comparison to a strong Q1 2016. We are expecting France to return to growth in the second quarter.

To summarize, very strong growth in our International business is coming from a number of sources including strong market trends, strategic investments and our success in bringing new value-added products to market.

Turning to the U.S., revenue grew 4%. Companion Animal grew 10% in the quarter while being offset by a decline of 2% in Livestock. The Livestock decline was due to our Swine business, where the timing of customer purchases had a negative impact in the quarter, and we continue to see competitive pressure on our vaccine franchise.

In the U.S., we have made some changes to our Fostera PCV and M. hyo vaccines, and based on a recent large comparative trial, we believe this product should be well received by customers and make us more competitive in this space.

The decline in Swine business was partially offset by growth in Poultry where we're seeing higher sales of antibiotic alternatives such as Zoamix.

Our Cattle business in the U.S. was flat for the quarter as an increase in herd size is contributing to growth in our reproductive franchises. Performance was also supported by growth in ACTOGAIN and our SYNOVEX franchise which was offset by a higher mix of low-risk cattle moving to feedlots.

Our medicated feed additive sales for both cattle and swine were negatively impacted in the first quarter by livestock producers' implementation of the Veterinary Feed Directive. This impacted U.S. livestock growth by about 3% as we continue to work with our customers on the implementation of VFD. Companion animal sales grew 10%, primarily due to the launches of Simparica and Cytopoint, as well as growth in Apoquel. This growth was partially offset by initial sales into expanded distributor relationships in the prior-year quarter.

We are pleased so far with the performance of Simparica in the first spring buy-in season that it was fully available in the U.S. We've initiated direct-to-consumer and additional promotional campaigns, which we believe will help build upon the success we have seen so far.

In U.S. dermatology, sales were $57 million for the quarter. Cytopoint has been well received in its first full quarter with a full USDA license and Apoquel is sustaining the base it built through the second half of last year.

As we are gaining more experience with a full supply of our dermatology portfolio throughout a calendar year, we do believe there will be seasonality to the revenue with the second and third quarter dermatology revenues being higher than the first and fourth quarters.

Overall, we continue to hear very positive feedback from our customers about Apoquel and Cytopoint. With the launch of additional promotional campaigns and DTC advertising we expect an acceleration of sales in the coming quarter. With the continued strong performance in the U.S. and the prospect for additional growth in international markets, we believe our global dermatology portfolio can grow to between $400 million and $500 million in the next three years.

Now turning to the rest of the P&L. Adjusted gross margin of 64.4% declined approximately 300 basis points in the quarter on a reported basis and was sequentially flat with the fourth quarter of 2016. Coming into 2017, we have made additional cost improvements in our manufacturing network. In the first quarter of 2017, we recognized higher costs associated with previously produced inventory which depressed our gross margin. This will also will also negatively impact Q2. As we progress into the second half of the year, our results will fully reflect more of the impact of our manufacturing cost improvements.

In addition, Q1 2016 contained some favorable items and Q1 2017 gross margin was negatively impacted by unfavorable foreign exchange versus last year. The first quarter results for adjusted gross margin are in line with our expectations and we have reaffirmed our adjusted cost-of-sales guidance for the year.

Adjusted SG&A grew by 2% in the quarter, with higher promotional expenses to support new product launches and higher penetration of Apoquel, offsetting expense reductions from our operational efficiency initiatives. Adjusted R&D was flat for the quarter with an increase in project spending offsetting fixed expense reductions for our operational efficiency initiative. Adjusted other income included lower foreign exchange losses compared with the prior year and the positive impact of a legal victory in Norway for our PHARMAQ business. This legal win will allow us to launch a vaccine for pancreatic disease in the world's largest farmed-salmon market this year.

The adjusted effective tax rate for the quarter was approximately 28%. The tax rate in the quarter is significantly improved from the prior year due to the realization of benefits that resulted from operational changes implemented in the third quarter last year. It also reflects the effects of discrete items, including a small benefit from the vesting and exercise of employee equity awards. The year-over-year improvement in our adjusted effective tax rate was a significant driver of adjusted net income growth of 10% operationally.

Of note, our one-time cash costs have come down significantly over time as we have moved beyond the efforts to stand up our company and execute on our operational efficiency initiative.

Now moving to guidance for full year 2017, the year is off to a good start for us, particularly with revenue. We are reaffirming our previous guidance and expect accelerated growth in adjusted net income as we get into the second half of the year, primarily due to the cost-of-sales trends I discussed earlier. As I said in our fourth quarter call, we expect slower income growth in the first half of the year and our current expectations are consistent with that view.

For the year, we continue to expect to achieve operational revenue growth of 5.5% to 7.5% and adjusted EBIT margin of 34% to 35% and operational growth in adjusted net income of 15% to 20%.

Our guidance for adjusted ETR of approximately 30% is based on current U.S. tax law and does not take into account any potential changes being discussed in Washington. With more than half of our adjusted pre-tax income in the U.S., a lowering of the U.S. corporate tax rate would have a meaningful benefit to us.

In the first quarter, we repurchased $125 million in shares and our guidance for reported and adjusted earnings per share reflects the share repurchase completed through Q1.

Just to summarize before we go to Q&A, we're off to a good start to the year with continued momentum in the areas we expected, such as new companion animal products in markets like China and Brazil. We see a good runway for continued growth that is in line with or faster than the market based on our diverse portfolio and recently launched products. Our operational efficiency program has been fully implemented at this point and is expected to achieve more than $300 million in savings in 2017.

We will continue to use some of these savings both internally and externally to support sound investments in our business and return excess capital to shareholders. And, we are reaffirming our outlook for 2017 and continue to project a stronger second-half to achieve our full-year targets.

With that, I'll hand things over to the operator to open the lines for your questions. Operator?

# QUESTION AND ANSWER SECTION

**Operator**: [Operator Instructions] And we can take our first question from Kevin Ellich with Craig-Hallum.

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Kevin Ellich
*Analyst, Craig-Hallum Capital Group LLC*

Q

>: Good morning. Thanks for taking my questions. Congratulations on a nice quarter. First off, could you maybe give us a little bit more detail on the strength that you're seeing in Companion Animal, specifically the strong growth in China, Brazil. And also, Glenn, you actually gave us some great detail on the dermatology sales. Could you break out what type of growth, year-over-year growth, did you see in Apoquel versus new sales of Cytopoint?

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

A

Thank you again for the questions. So, let me take first this trend in Companion Animal in China and Brazil. We have seen that the adoptions and also the medicalization rates in both these countries are growing. We identified this opportunity and we invested to capitalize on that, so we expanded our field force in China and Companion Animal and Brazil and the results are showing a very strong revenue growth. We also benefit in China with introduction of the new vaccines and also in Brazil now we have also almost all our portfolio approved and products like Simparica has been extremely well accepted by the market and they're generating very positive growth. Glenn?

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

A

Kevin, in terms of your question related to Apoquel and Cytopoint growth, so year over year, the Dermatology portfolio grew 47%. When you look at – actually the segment grew – Apoquel grew 47%, the segment grew 66%, so really Cytopoint, this was really the first quarter of full availability with full USDA license. So, it's almost 100% growth in terms of Cytopoint. So just to break that down again, the derm portfolio is 66% growth for the quarter, Apoquel 47% growth for the quarter.

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

A

Next question, please.

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**Operator**: And we can take our next question from Gregg Gilbert with Deutsche Bank. Please go ahead.

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Esther Rajavelu
*Analyst, Deutsche Bank Securities, Inc.*

Q

Hi, this is Esther Rajavelu for Gregg Gilbert. In Livestock, do you anticipate any changes in the vaccines portfolio offsetting negative impact from the feed additives going forward for the rest of the year?

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

A

Well, this has partly been affecting in terms of vaccines mostly in swine and we have been working with our PCV2 and M. hyo vaccine. We have been developing additional trials and the trials are showing very positive results in terms of efficacy and we are convinced that now we have a product which is very competitive and this product will gain momentum in the U.S. market. We also introduce now in the international market the PCV2 and M. hyo vaccine and also this vaccine also will generate positive growth in the international markets.

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Esther Rajavelu
*Analyst, Deutsche Bank Securities, Inc.*

Q

Thank you.

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

A

Next question, please.

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**Operator**: We take our next question from Derik de Bruin with Bank of America. Please go ahead.

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

Q

Hi. Good morning. Thanks for it. Two quick questions. Was there any stocking or any outsized orders particularly OUS? And then also just on some of the dynamics in the livestock market, the data's been showing that herd size is increasing and clearly your data is reflecting that. Is there any signs at all that there could be potentially some oversupply and that they're thinking about doing some cattle herd culls? Thanks.

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

A

Well, let me take the question on livestock and cattle. So, we see the cattle business also showing that very positive trend, we still see that the herds are growing in countries like U.S. and also in Australia. Prices are also showing a positive trend. Most recently, on the news said that the cattle futures are 18-month high, which is also a positive. Also in the U.S., their feedlots and stockers are back to profitability. So, all this is indicating that the cattle business are showing a positive sign.

For the year, we expect that for Zoetis, that the cattle will be growing mid-single digits which is positive and also the positive element that we have seen that the consumption of beef is also growing. Even in some parts of because of China consumption but these also accelerating exports. This is also helping producers to capitalize on investment that they been making in the last year. So, we see that I think the cattle business, it will be showing a positive trend, in general, for the market and also positive for Zoetis.

We understand that in the first quarter we had some challenge, especially in the U.S. The challenge came from mild winter. It also generated a low risk profile for animals and then this affected our premium antibiotics. The other impact that we had in the first quarter in cattle was related to the implementation of the Veterinary Feed Directive; that created some challenge.

In the cattle, especially in the small customers, they were not having a veterinarian associated with these operations. We expect also that this will be corrected in the coming months. But again, positive outlook for cattle, both in the U.S. and international. And now then, Glenn, you will answer the comment on stocking in the quarter.

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

A

Yes. In terms of the question on stocking in the quarter, there was no material stocking in the quarter. Perhaps in some markets, particularly Vietnam, there was some elevated sales in the quarter that will stall it. It's probably expect to reverse to some degree in Q2. The only other thing I would point out, particularly in the U.S. with Simparica, we had very strong sales of Simparica in the quarter. I wouldn't call that a stocking issues. It's more just the season for parasiticides in the U.S. and how the veterinarians typically make their purchases.

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

A

Next question, please.

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**Operator**: We can take our next question from Jon Block with Stifel. Please go ahead.

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Jonathan Block
*Analyst, Stifel, Nicolaus & Co., Inc.*

Q

Thank you, and good morning. Two questions. I'll ask them both up front. Juan Ramon, maybe for you. Just some high-level commentary on the altered structure, if you would, with the distributors on the Companion Animal side where I think the contracts are more volume based, if you would, rather than exclusivity. How has that performance been? Has it been in line with your expectations? And then, Glenn, just maybe on the gross margin cadence, I know you guys don't want to guide for the quarter, but how do we ramp the 67%-plus for the year? Can we expect a modest improvement in 2Q and then much more pronounced in 2H? Thanks, guys.

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

A

Thank you, Jon. Let me answer the question on what was shown on that. Maybe a little bit background on these questions. So, we launched many products, many new products, in Companion Animal and then with these launches we decided to review the collaboration with the distributors in the U.S. and then as a result of this review in 2016, we decided, in agreement with the distributors, also to include in their promotional portfolio our vaccine for companion animals. The results of this collaboration was very positive for them and also for Zoetis.

Then in 2017 we decided to expand this collaboration not only to vaccines plus some other products that they were responsible before, also to our parasiticide portfolio, REVOLUTION, ProHeart 6, and Simparica. All indicators are very positive, and now thanks to our direct presence together with the support of distributors, we have been increasing significantly our sales force in markets that we know that are highly competitive, and this additional volume that has been generating through all these regional portfolio has been also supporting the rest of the portfolio.

Those that are affected by generic competition that, thanks to these newer studies, we are still performing in line with expectations, and we have not seen significant change on the trend of general impact in 2017. So overall, very pleased with the new way that we are collaborating with distributors. And one of the impact that also we have seen that's very positive has been the evolution of Simparica, that now we have our sales force, and the sales force of distributors supporting Simparica.

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

A

And in terms of gross margin trending throughout the year. So, in Q2 we will still have somewhat of a negative drag on margin from the impact of the costs of previously produced inventory, but the impact will definitely be smaller than it was in Q1. Then as we get into Q3 and Q4, margin improves significantly as it really fully recognized the benefits of the improved costs that we were able to deliver as far as the operational efficiency initiative. So that should give you some understanding of the trending throughout the year.

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

A

Next question.

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**Operator**: Our next question comes from Jeffrey Holford with Jefferies. Please go ahead.

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Jeffrey Holford
*Analyst, Jefferies LLC*

Q

Hi. Thanks very much for taking my questions. So, it looks like you had a pretty strong Q1 in international. Is there anything out there through the rest of the year, just issues you may be concerned about that stops you at least raising the bottom end of your revenue guidance for the full year 2017? And then just secondly, on Nexvet, wonder if you might just give us a little bit more color on any timing and the size of opportunities within their pipeline that you might want to just highlight for us to give us some expectation of when that might start to contribute? Thank you.

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

A

Let me start with the question on Nexvet, and then Glenn will provide the comments on the guidance and most of the performance being international. So on Nexvet, we just announced the acquisition, but it is an acquisition of a company which is based in Ireland, and we need to follow their regulations and the requirements of the Irish authorities. So at this point, I think we have a lot of limitations, and let's wait until this transaction is concluded, and then I will provide all details of what we expect from Nexvet; and also timing of new product introductions.

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

A

And in terms of revenue and guidance for the year. So when you look at the performance for Q1, on a global basis we delivered 6% revenue growth for the quarter. That's very much in line with our full-year guidance of 5.5% to 7.5%. So the performance in the quarter was in line with what we expect the year, which is why we believe the guidance that we have is appropriate from a revenue perspective. International performance was positive in the quarter at 9% revenue growth, but again, definitely in line with our expectations and what we would expect throughout the year.

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

A

Next question, please.

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**Operator**: We'll take our next question from Erin Wright with Credit Suisse. Please go ahead.

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Erin Wilson Wright
*Analyst, Credit Suisse*

Q

Great. Thanks. A follow up to John's question on the gross margin. You had a particularly strong quarter in companion animals, typically a higher margin business for you. Your gross margin was essentially in line with your quarterly guidance that you gave on the last call. What can you speak to as far as the moving parts in the gross margin, and particularly just following the strength in that higher margin business for you? And then I understand you can't speak to Nexvet, but how should we think about the traction you are seeing with Cytopoint and the vision on the prospects for monoclonal antibodies in general, given now you've doubled down in the space with the recent acquisition of Nexvet? Thanks.

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

A

So again, let me start with the comment on monoclonal antibodies and Cytopoint. That's actually what we see with the addition of Nexvet, without getting into details of products or timing of launches. So definitely the innovation that we have seen at Nexvet in terms of monoclonal antibodies combined with the expertise that we have developed with Cytopoint and the manufacturing capability that we also developed at the time of Cytopoint – this will be a significant opportunity in combining Nexvet capabilities with our capabilities.

On top of that, we have based on that present knowledge on how to commercialize monoclonal antibodies, and we see a significant opportunity of bringing to the market new options in terms of pain. [ph] Still pain is a main need (38:22) in the Companion Animal market, and definitely we see another opportunity of expanding the market with introduction of monoclonal antibodies for cats. So we see that it has significant strategic rationale on this acquisition, and we see also that this will generate significant value to Zoetis over time.

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

A

And, Erin, in terms of gross margins, so as you mentioned it is in line with our expectations for the quarter. And in terms of mix, there was some up and downs. As you mentioned, Companion Animal performed very well, typically some of our higher margin products.

Also though, we had a decline in performance in some of our premium antibiotics, which are also very high margins. And International also had higher growth, and International in general has lower margins than the U.S. So, overall the mix ended up being neutral to our expectations and still kept us in line with where we thought we'd be for the quarter.

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

A

Next question?

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**Operator**: Our next question comes from John Kreger with William Blair. Please go ahead.

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John C. Kreger
*Analyst, William Blair & Co. LLC*

Q

Hi. Thanks. Just wanted to follow up on your comments about Stronghold Plus. When do you expect that product or something like it to be approved and launched in the U.S. in cats? And how about for dogs, either in the U.S. or Europe? Thanks.

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

A

Well, this combination is a topical combination, and technically it will be focused on cats. But we also discussed that we'll be using sarolaner as a platform to develop other combinations. These other combinations will be oral, and they will be focused on dogs.

Your question about when do we expect to launch on the U.S., this is not yet defined. We are working with the U.S. regulators on answering and developing all the details for a demonstration, but at this point we have not provided any timing of the approval. As we progress on the discussion with the U.S., then we'll provide the details on the timing.

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John C. Kreger
*Analyst, William Blair & Co. LLC*

Q

Okay. Thanks. And then a follow up on PHARMAQ. Given your legal victory, can you just talk about where you think that business can go over the next couple of years? And maybe just even reset the longer-term strategy there? Is that a business that can start to be a more material contributor over the next few years? Thanks.

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

A

Well, thank you, John, for the question. We are convinced it's an area of growing opportunity, and we know that already the farmed fish is exceeding the consumption of wild fish. Still, there is a lot of use of antibodies in these segments. We expect that these antibodies will be replaced by vaccines. PHARMAQ is a leader in terms of developing vaccines.

We are very pleased with the interaction of a new vaccine in Chile for SRS, which is also helping the reduction of antibiotic use in this country. But then the next opportunity should be China, Vietnam and other countries. Already they are number one in terms of farmed fish production. And again, we are working on developing vaccines that will be targeting these countries.

There was also the legal litigation in Norway. It's opening to us the opportunity of launching a new vaccine for pancreatic disease which is very important in Norway and it's also helping us really to support the rest of the portfolio in Norway. We communicated that in 2017 that we expect to generate $125 million and that will be a significant, growth. In the first quarter, also, we show very positive growth for PHARMAQ and we are expecting for the year to generate more than 30% growth in terms of PHARMAQ. So, the prospects are very positive and we'll continue investing not only in salmon in where we have most of our revenues to date, but also in tilapia and other fishes that will be important in the future. Next question, please.

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**Operator**: Our next question comes from David Risinger with Morgan Stanley. Please go ahead.

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David R. Risinger
*Analyst, Morgan Stanley & Co. LLC*

Q

Thanks very much. Well first, I wanted to congratulate you as well on the results. I just wanted to ask about the outlook on a couple of items. First of all, I think that you had mentioned 12% operational Companion Animal growth in the first quarter. Just wondering if we should expect that to accelerate or decelerate in coming quarters.

Second, with respect to other expenses and the tax rate, which surprised me this quarter, the other expense item was $35 million in the first quarter. Wanted to get your guidance for how we should think about it in the second quarter and for the full-year. And then the same thing on the tax rate. The tax rate was 27.8%. Wanted to understand what you would suggest for the second quarter sequentially. And then finally, it sounds like the 2%

price increase that you've seen historically and you saw this quarter is sustainable. Just wanted to confirm that, in coming quarters and for the foreseeable future, you continue to expect the 2% benefit from price for your business. Thanks so much.

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

A

Thank you, Dave, and I will provide the comment on the outlook for Companion Animal and then Glenn will go to the details of tax and some of the questions that you asked including price. So on the outlook, so we have at least a 12% in Companion Animals. So we expect for the year that Companion Animal will continue growing at double digits and we think that this 12% it's probably a trend that we will see for the rest of the year. We should also have the benefit of the growth of Apoquel mainly coming from also the full introduction of international markets where now they are, some of the markets, they are now at launching pace.

We also expect that Apoquel in the U.S. will continue growing. But now more than Apoquel, I think it's important to discuss about the Dermatology portfolio, including Apoquel and Cytopoint, but if we talk about Apoquel in the U.S., for instance, we are very pleased with the level of penetration in clinic. It's about 94% which is very good, but we only have 47% market share in terms of patients. So we still see opportunity for continue growing and taking share from steroids that still account for 30% of patients.

Cytopoint, it's definitely has been very well accepted by the market, but still a very low market share in terms of patients, only 5%, but growing also very fast in terms of penetration. So, both products will drive growth and very important also Simparica in where we have seen very positive international growth. Now we have the benefit of this year of enjoying the full season so we have the product and we have seen that this product is performing [ph] that is positive for (47:07) performing extremely well. And one of the things that we've seen that is also helping that is the cooperation with distribution and we expect also that in the next coming months we'll see the impact, also, of our DTC campaign. So in summary, we expect that this 12% growth in companion animal will be maintained for a full year.

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

A

Hey David, this is Glenn. Just to your other questions in terms of how the quarter relates to the full year. I'm not necessarily going to break down quarter by quarter, but just how Q1 relates to the full year. So, the 2% price increase that we saw for the quarter we do expect to be maintained throughout the year, and in general we expect to generate 2% to 3% price increase, so nothing has changed from that perspective.

In terms of the tax rate, the guidance on the adjusted ETR for the year is 30%. We came in at about 28% in Q1, really driven by A, some discrete favorable items, and also the recognition of some of the benefits related to employee stock options and restricted documents, and the tax effect of those in the quarter. So those had a favorable impact in the quarter versus what the trending will be for the full year.

And then related to other expense. So, our other income in the [ph] doc (48:25) line was favorable in the quarter really driven by two key things. A, we had lower hedging costs than we've had in the past and also we had the PHARMAQ settlement for the PD vaccine that Juan Ramon spoke about just before.

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

A

Next question, please.

**Operator**: We can take our next question from Alex Arfaei with BMO Capital Markets. Please go ahead.

Alex Arfaei
*Analyst, BMO Capital Markets (United States)*

Q

Okay good morning, folks, and thank you for taking the questions and congratulations on a good quarter. A couple of clarifying questions for Juan Ramon first. First confirming that you do expect U.S. livestock to return to growth in the second half, just want to make sure we're clear on that. And I didn't catch the Apoquel market share you stated.

And a couple for Glenn if I may. As cash conversion improved this year, are you considering a more aggressive dividend policy to better reflect the sustainability of your business? And what are your thoughts on tax reform and how could it possibly impact Zoetis as you evaluate the various policies that are being discussed? Thank you very much.

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

A

Thank you, Alex, and the answer to the U.S. livestock. I think we expect growth in the U.S. for our livestock, but mainly it will be important to provide some details on the different species in livestock, starting with swine. We expect mid to low single digits, and we expect that the PCV2 vaccine will help also to gain momentum in terms of revenues. We also think that the swine business in the U.S. is also having the benefit of high exports. The exports are growing 18% in the U.S. and this is also helping the producers to generate profitable results, and we are now, in our opinion, having the portfolio that will be creating that growth in the rest of the year.

In the case of poultry, poultry we expect that the market will be showing very little growth. But on the contrary, Zoetis will be generating positive growth and growing faster than the market in poultry in the U.S.

And finally, in cattle. In cattle, we faced down that challenge in the first quarter. The challenge of a milder winter, low risk profile, that also had an impact in our premium anti-infective. Also, as I mentioned the implementation of the Veterinary Feed Directive, that also had impact on our medicated feed additives. We expect that all these challenging implementation that affected the small producers will be managed in the future, and this will help also to have the fuller use of our products in the coming months.

In the cases that are positive for cattle that make us positive about this segment, prices are increasing, and as I mentioned, the future prices are hitting highest in the stock. Also, the placement of the feed lot increased by 6%. And very positive, also, the animals are now moved with medium size compared to heavy size in the future, which is also increasing the risk profile of these animals. And again, another indicator which is a positive in cattle is that as feedlots and stockers are back to profit. So all in all, we think that the cattle market are having positive prospects. And we have the portfolio in our company also to generate positive growth in the rest of the year.

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

A

So, Alex, in terms of the cash conversion as you indicate, as we get outside of the costs of the operational efficiency initiative and a lot of the stand-up costs, our cash conversion is improving significantly. In terms of how we'll prioritize those – that additional availability; A), we'll continue to look internally for areas of high growth and investment. We'll also aggressively look at business development as well as an area.

In terms of dividends, we'll continue to grow our dividend pretty much at or faster than the growth in adjusted net income. And really where we'll exhibit flexibility in terms of returning capital to shareholders will be with share repurchase. We recently announced the $1.5 billion share repurchase program. We indicated that that was flexible in nature. Just for context, in Q1, we repurchased $125 million in share. And as we go throughout the year, we'll continue to evaluate the magnitude and pace of share repurchase.

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

Next question, please?

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

And also just in terms of – in terms of tax reform. As we've said, we do have more than half of our pre-tax income in the U.S., so a change in the U.S. rate would definitely be favorable to us. Really, the magnitude of that favorability will really depend on the totality of the legislation. And we'll understand that more as that becomes more clear.

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

Next question?

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**Operator**: Our next question comes from Brett Wong with Piper Jaffray.

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Brett W. S. Wong
*Analyst, Piper Jaffray & Co.*
Q

Yes. We're seeing some pressure in the dairy industry in the U.S. due to tariffs being put in place in Canada putting stress on trade. So granted, prices are still up year over year, but are you seeing any weakness in that market or expect to see softness in demand for your products in that sector?

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

Yes. I lost the beginning of your question, so you were talking about dairy has moved in the U.S. And what else?

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Brett W. S. Wong
*Analyst, Piper Jaffray & Co.*
Q

Yes. Sorry about that. I was just wondering if you can comment around the U.S. dairy market, and we've been seeing some pressures there due to trade impact and so – or potential trade impact. And so just wondering if you are seeing any weakness yet or if you expect to see any softness there. And I know that prices are still elevated year-over-year, which is positive, but what you're seeing, if there's any weakness so far.

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

Well, the dairy producers, maybe they are now generating lower profit than in the past, but they're still generating a profit. So, we have not seen any significant change in terms of number of animals, which is defining the animal sales revenues. So, I think it is something that is stable. And in other markets, we have seen that they are recovering very well and countries like New Zealand are now back to much more profitable situation compared to the past. So overall, the dairy business for us, it's positive. But it also – we have some challenge in Western Europe in the importations to Russia has also been limiting the opportunity for revenues for some European dairy producers. But overall, our dairy business, it's showing positive growth for the year.

Next question, please?

**Operator**: Our next question comes from Jami Rubin with Goldman Sachs. Please go ahead.

Divya Harikesh
*Analyst, Goldman Sachs & Co.*
Q

Hi. This is Divya Harikesh on behalf of Jami Rubin. You described growth for the dermatology portfolio of $400 million to $500 million over the next three years. Can you help explain how much of that's coming from Apoquel versus Simparica and Cytopoint and just comment on your long-term expectations for these products? With Apoquel, have you already reached a stage where a lot of the growth coming forward is going to be from Simparica and Cytopoint that are in earlier stages of ramp. So, it would be great to better understand that.

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

Thank you for the question. But maybe it's important now that when we discuss about Apoquel and Cytopoint, we discuss combining this portfolio. Both our products are targeting the same type of medical conditions. It's true that Apoquel, they have more indications than Cytopoint, but it's still – it's something that the market is understanding fully, how to use these products, considering the dogs, considering pet owners' preference and also the decision of veterinarians.

So, I think it's important that we are not trying now to identify how much will be coming from Apoquel, how much with Cytopoint. Definitely something that we'll be providing this information on actual, but I think the important thing is that we expect to generate $400 million to $500 million revenues in three years' time which is, in my opinion, an increase compared to previous estimations and is related to the reaction of the market.

We still see significant opportunities for growing in international. In international, we have many countries where we still have on launching pace. But in the U.S., we see great opportunities, as I mentioned, if we take Apoquel and Cytopoint combined, the number of – the market share in terms of patients is about 50%, 52%. So still we have a lot of opportunities for continuing growing that in this area. We expect also that the growth also will come from increasing awareness of pet owners through our digital campaign in the U.S. So, we expect that they are still significant growing opportunities for our Dermatology portfolio in both international and the U.S.

Next question, please.

**Operator**: Our next question comes from Chris Schott with JPMorgan. Please go ahead.

Christopher Schott
*Analyst, JPMorgan Securities LLC*
Q

Great. Thanks very much for questions. Just two here. First on the gross margin improvement as we think about the next few years. I think you've highlighted a 200-basis-point improvement by 2020 as you optimize infrastructure. Can we just get a little bit more color on how to think about that? Is that going to be a gradual improvement as we think about 2018, 2019, 2020? Or more of a step-function improvement as you do all that work and then we get more in 2020, it has a big step up? My second question was coming back to capital deployment and just like a little bit more about your longer-term leverage targets and where you'd like to see the company over time. I'm just trying to get my hands around a little bit more how much capital you're going to have to work with as you consider the various options for cash deployment going forward. Thanks so much.

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

A

So, Chris, so in terms of the 200-basis-point improvement that we expect in gross margin through 2020, we do expect it to be gradual. It's not going to be necessarily one-step change. There are activities that need to occur over those three years to generate that 200-basis-point improvement, primarily in terms of moving products from one location to another for manufacturing. So that will be a gradual improvement.

In terms of capital deployment and our debt ratios, we're still targeting a gross debt ratio of 2.5 to 3 and we believe that is appropriate for our company and that will be what we'll be targeting for the next number of years.

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

A

Next question, please.

**Operator**: Our next question comes from Kathy Miner with Cowen & Co. Please go ahead.

Kathy M. Miner
*Analyst, Cowen & Co. LLC*

Q

Thank you. Good morning. Just two questions. First, and I'm not sure if I heard this before, but last quarter you had talked about having $50 million in sales still to work through the P&L from the streamlining. Could you tell us how much of that impacted Q1? And will the remainder be in the second quarter? And the second question is on antibodies in companion animals. Given your interest with both the IL 31 and your pending acquisition of Nexvet, have you also looked at antibodies in the oncology area, specifically anti-PD1s for use in cats and dogs? Thank you.

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

A

In terms of the $50 million in sales that was a challenge to growth for 2017. That was really related to the product rationalizations and the fact that we still had $50 million of sales in those earlier in 2016. So really 1% impact in terms of growth for the year is what we're anticipating for 2017. We expected to see the majority of that impact in the first half of the year, so about 2% impact from the product rationalizations in the first half of the year, which is what we saw in the first quarter. We expect a similar impact in the second quarter and then minimal to no impact in the second half of the year.

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

A

And the question on monoclonal antibodies. Definitely now with the expertise that we have, that we gained thanks to Cytopoint, IL-31, and also the addition of Nexvet. We see opportunities of using the monoclonal antibody as another platform to develop other products in other indications. And oncology is one of the targets, but we are also discussing other areas that monoclonal antibodies be also responding to medical conditions or opportunities for some efficiencies in livestock.

Other question, please?

**Operator**: It appears we have no further questions at this time. I will now turn the program back over to Juan Ramon for any final or closing remarks.

## Juan Ramón Alaix

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

Thank you very much for joining us today. And we'll be pleased to have following – follow-up comments with our Investor Relations group that will also be pleased to interact with you. Thank you.

**Operator**: And this does conclude today's program. Thank you for your participation. You may now disconnect, and have great day.