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Zoetis, Inc. (ZTS)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Second Quarter 2019 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 opened for your questions following the presentation. [Operator Instructions] In the interest of time, we ask that you limit yourself to one question and then queue up again with any follow ups. Your line will be muted when you complete your question. [Operator Instructions]

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

Steve Frank

Vice President-Investor Relations, Zoetis, Inc.

Thank you, Keith. Good morning, everyone, and welcome to the Zoetis Second Quarter 2019 Earnings Call. I am 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 statement in today's press release and our SEC filings, including, but not limited to, our annual report on Form 10-K and our report 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 or 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 filing dated today, August 6, 2019. 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. Our second quarter results demonstrate many of the competitive advantages that have made Zoetis the world leader in animal health. We have been able to deliver steady and reliable financial results for our investors since 2013, consistently growing our revenue faster than the market and growing our adjusted net income faster than revenue each year.

It is a track record driven by leading innovation, a diverse and durable portfolio and a clear strategy that begins and ends with our customers, their success, and the health of their animals.

Over the last few years, we have consistently brought new innovation to market from our R&D labs, most notably in dermatology, parasiticides, and vaccines with products like Apoquel and Cytopoint, Simparica, REVOLUTION PLUS, and Stronghold Plus, and various new vaccines in our Fostera, SUVZXYN, and Vanguard product lines.

We invest significantly in our productive R&D and rely on the support of our commercial manufacturing and supply chain teams to maximize the growth of our products and services. We also invest internally and externally to maintain the most diverse and durable portfolio in the animal health industry. This approach has helped us perform well, even in the face of shifting weather patterns, changing market conditions, and the impact that emerging businesses have on our customers.

Recent external investment in diagnostic, nutritionals, and digital solutions keep us evolving in line with market trends, while enhancing the integrated solutions we offer to our customers. At the same time, better supporting our medicines and vaccine portfolio. This consistent performance is made possible by the outstanding, talented, and dedicated Zoetis colleagues that execute our plans and growth strategies.

Turning now to our financials. We continue our strong performance through the first half of the year. We had 14% operational revenue growth in the second quarter. Diagnostic sales from the Abaxis acquisition accounted for 5 percentage points of that overall growth.

Our Companion Animal portfolio is continuing its positive momentum, with 22% operational revenue growth, based on diagnostic sales from the Abaxis acquisition, a strong sales of our key dermatology products, and parasiticides.

As we anticipated, Livestock product sales returned to growth in the second quarter at 3% operationally with increases across all species. Poultry products led the way, growing 15% operationally. And this was partially offset by more modest growth in fish, cattle, and swine, which was impacted by African swine fever in China.

As we indicated last quarter, African swine fever remains a major factor for the overall industry growth in 2019. And industry forecasts expect the animal health industry to grow around 4% compared to 5.6% in 2018. We believe our diverse portfolio across the species, geographies, and therapeutic areas will help us once again to grow revenues faster than the market in 2019.

In terms of profitability, we grew our adjusted net income by 17% operationally in the second quarter and generated our highest gross margin ever.

Looking at the rest of the year, we are confident in our latest innovation and core business to generate that growth. And we have increased our full year guidance for 2019 based on the positive momentum of our Companion Animal portfolio and, to a lesser extent, the favorable impact of foreign exchange rates.

As we look ahead, we are making good progress with innovation and investment that will generate our future growth.

In July, Zoetis received a positive opinion from the European Medicines Agency for our three-way combination parasiticide for dogs. This decision brings Zoetis and veterinarians one step closer to offering pet owners a new choice in the prevention of heartworm disease and lungworm, while also treating fleas and ticks and gastrointestinal worms. We look forward to a final decision from the European Commission later this year.

Regulatory reviews for the three-way combination are also underway in the U.S., Canada, Australia, Brazil, and Japan, with further submission expected in China and Mexico this year. If approved, Zoetis anticipates this product coming to the market in the first quarter of 2020.

Once we have our final label approved, we'll be able to share more insight on our market expectation for this triple combination product. It is fair to say that we expect this product to be a significant entrant in the more than $4 billion global canine parasiticide market.

In other parasiticide news, in July, we gained U.S. Food and Drug Administration approval of ProHeart 12, the industry's only one-year injection to prevent heartworm disease in dogs from one year of age and older.

We are steadily building an innovative and fresh portfolio of parasiticides that will give veterinarians a range of choices for dogs and cats. Simparica, REVOLUTION PLUS, ProHeart 12 and [ProHeart] 6, and the anticipated triple combination product, once approved, will make us even more competitive and able to challenge today's market leaders in parasiticides.

We are sustaining and expanding our portfolio in an area where Zoetis was underrepresented historically.

In the area of monoclonal antibodies, we are the industry leader in innovation with our ground-breaking dermatology product, Cytopoint. And we continue to advance our pipeline in other areas like pain.

I am pleased to announce that we have filed in the U.S. and EU for a new monoclonal antibody candidate to control pain associated with osteoarthritis in cats. And we expect approval in 2021.

To support these new Companion Animal products coming through our pipeline and to maximize sales of our current portfolio, including diagnostics, we have already added additional field force resources in international markets. And we are beginning to expand our field force in the U.S.

In the second quarter, on the Livestock side, we have expanded our Fostera swine vaccine franchise with approvals of different formulations in new geographies.

For example, Fostera Gold PCV MH was approved in Brazil. This vaccine, which is now commercially available in the U.S., Canada, and several other markets, provides the livestock farmers with greater options and flexibility in protecting pigs from PCV2 and M. hyo [M. hyopneumoniae]. And Fostera PCV, a single dose vaccine that aids in the prevention of PCV2, was approved in China.

We also combine our internal innovation approach with external collaborations. In line with that, we recently signed an important R&D agreement with Colorado State University to establish a research lab there. Our teams will explore the livestock immune system and target the discovery of new immunotherapies that could pave the way for alternatives to antibiotics in food production animals.

We also continue to support future growth through business development activities. In July, we announced plans to acquire Platinum Performance, a privately held nutrition focused animal health company that is highly regarded in the equine community. Platinum features premium nutritional product formulas and a unique approach to the field of scientific wellness for horses as well as dogs and cats.

The expansion in nutritionals will further strengthen our portfolio in the equine and pet care markets. And it aligns well with Zoetis, increasing focus on health and wellness as part of the continuum of animal care.

We expect the acquisition to be completed in the third quarter of this year after meeting customary closing conditions. Our plan is to expand the Platinum Performance equine business through U.S. field force, accelerate the growth in its pet care formulas with veterinarians and pet owners through our digital marketing capabilities, and evaluate international expansion opportunities over the long term.

Finally, in closing, we remain on track for a strong year, based on our diverse portfolio. And we are making important progress in key areas, such as parasiticides, vaccine, monoclonal antibodies, diagnostics, and digital and data analytics, areas where we see both near- and long-term growth opportunities.

I will now hand the call over to Glenn. Glenn?

Glenn C. David

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

Thank you, Juan Ramón, and good morning. As Juan Ramón said, we delivered another strong quarter, growing revenue 14% operationally and adjusted net income 17% operationally. Based on our positive performance in the first half of 2019, we are increasing our revenue and adjusted diluted EPS outlook for the year. I'll review updated guidance in more detail after discussing Q2 performance.

Reported revenue growth for the second quarter was 9%, including a 5% negative impact from foreign exchange, primarily driven by the continued strengthening of the dollar against the euro and Brazilian real. Excluding the impact of the Abaxis acquisition, operational revenue growth for the quarter was 9%, with price contributing 4% and volume contributing 5%. Key dermatology products contributed 2%, other in-line products 2%, and new products 1%. All species contributed to growth this quarter, with Companion Animal growth continuing to outpace Livestock.

Companion Animal operational revenue growth of 22% was driven by legacy Abaxis products, key dermatology products, and parasiticides. Excluding the impact of the Abaxis acquisition, Companion Animal grew 14% operationally.

Livestock operational revenue growth of 3% was driven by all species, including swine, despite the impact of African swine fever in China. Poultry was the primary contributor to Livestock growth internationally and in the U.S., and international sales of cattle also contributed.

Legacy Abaxis products contributed 5% to total Zoetis operational revenue growth in the quarter, with sales of $65 million. This represents a decline over the pro forma revenue from the prior year, primarily driven by product launches and initial distributor stocking, which occurred in the first half of 2018.

We expect improved results in the second half of 2019, with double digit revenue growth driving full year pro forma growth in diagnostics products. Our focus continues to be on the integration of the legacy Abaxis products into our portfolio, allowing us to leverage our innovative offering of diagnostics and therapeutic products and international expansion.

Our key dermatology portfolio continued solid growth this quarter, with sales of $182 million, a 30% operational increase over the prior year. Growth in this portfolio was driven by the ongoing expansion of the addressable market, increasing market share, price, and additional launches of both Apoquel and Cytopoint into new markets. We expect to exceed $700 million in revenue for this portfolio in 2019.

Other in-line products also contributed strong growth in the quarter including Simparica, with $69 million in revenue and 40% operational growth. This growth was partially offset by the ongoing impact of African swine fever.

New products, including our topical parasiticide for cats, REVOLUTION PLUS and Stronghold Plus, our swine combination vaccines and Core EQ Innovator in equine also contributed to drive growth this quarter.

Now let's discuss the revenue growth by segment for the quarter. U.S. revenue grew 15% in the second quarter. Companion Animal grew 23%, while Livestock grew 3%. Excluding the impact of the Abaxis acquisition, U.S. revenue grew 9%.

Companion Animal sales in the quarter were driven by sales of legacy Abaxis products, our key dermatology portfolio, and a number of our in-line products including Simparica, CLAVAMOX, CERENIA and ProHeart 6. Excluding the impact of the Abaxis acquisition, Companion Animal growth was 13%.

U.S. dermatology sales were $127 million for the quarter, growing 27%, driven by market expansion, increasing market share, and price. Simparica sales in the quarter were $40 million, growing 33% over the prior year. Simparica benefited from promotional investments leading to increased clinic penetration and market share gains.

U.S. Livestock sales returned to growth this quarter, increasing 3%. Poultry was the primary driver of U.S. Livestock growth due to the strong performance of our portfolio of alternatives to antibiotics in medicated feed additives in this fast growing market. Lack of efficacy and supply constraints of competitor products also contributed to growth of our products.

Our swine portfolio contributed modestly to growth, driven by promotional programs in the quarter. Our cattle products declined modestly this quarter, negatively impacted by ongoing dairy market challenges as well as wet weather impacting the movement of beef cattle to feed lots. These market challenges were partially offset by price.

Overall, a strong quarter for our U.S. business. Innovation, diversity, and consistent field force execution are all helping to deliver positive performance.

Turning now to our International segment. Revenue grew 10% operationally in the second quarter. Companion Animal operational revenue growth was 21%, while Livestock operational revenue growth was 4%. Excluding the impact of the Abaxis acquisition, International revenue grew 8% operationally.

Companion Animal product growth was driven by key dermatology products, parasiticides, namely Simparica and Stronghold Plus, and the addition of legacy Abaxis products. Excluding the impact of the Abaxis acquisition, Companion Animal growth was 16%.

International Livestock also returned to growth this quarter, driven primarily by strong performance of our poultry portfolio, primarily vaccines and medicated feed additives. Our cattle portfolio also contributed to growth, resulting from the favorable comparison to the prior year, which was negatively impacted by a national trucking industry strike that occurred in Brazil. Our swine portfolio was flat compared to the prior year, with growth in vaccines, including new products, offset by the impact of African swine fever in China.

Now I would like to highlight a few markets in the quarter.

Beginning with China, revenue declined 1% operationally, which is strong performance considering the negative impact of African swine fever. Our Livestock portfolio in China declined 18% operationally.

The outbreak of African swine fever continues, challenging the supply of pork. Latest estimates assume a range of 30% to 70% of the swine herd will be impacted. We now anticipate the full year impact to our swine revenue to be approximately $50 million.

We continue to anticipate other regions, primarily Brazil and the EU, to increase exports of pork to China. However, the timing and magnitude remains uncertain, as it takes time and investment in infrastructure to increase production.

Our Companion Animal products continued to perform well, growing 22% operationally in the quarter. Sales from parasiticides, newly launched Apoquel, and vaccines were the primary drivers of growth.

Moving on to Brazil. Sales grew 24% operationally, driven by Companion Animal growth of 36% and Livestock growth of 19%. Companion Animal revenue growth in Brazil was driven by parasiticides, primarily Simparic, and our key dermatology portfolio. We recently launched Cytopoint into this growing Companion Animal market and are pleased with its performance so far.

Livestock growth in Brazil was primarily driven by a favorable comparison to the prior year when a national truck driver strike negatively impacted the results. We anticipate an unfavorable impact in Q3 2019 results for Brazil related to the positive impact that the end of the strike had in Q3 2018.

The UK also performed well this quarter, with operational revenue growth of 24%, with Companion Animal growing 38% and Livestock growing 7%. Companion Animal growth was primarily related to our key dermatology portfolio and the addition of legacy Abaxis products. Livestock growth was attributable to increased sales of cattle products.

In Mexico, sales grew 20% operationally, driven by Companion Animal growth of 25% and Livestock growth of 18%. This market benefited from key dermatology sales, including the launch of Cytopoint, and legacy Abaxis products in Companion Animal, while Livestock growth was related to market conditions driving growth across the cattle portfolio.

Other emerging and developed markets also continued to perform well this quarter, particularly in Companion Animal and poultry. Summarizing International performance, we demonstrated continued strength across all species and almost all international markets, despite the impact of African swine fever.

Now moving onto the rest of the P&L. Adjusted gross margin of 70.5% increased approximately 180 basis points in the quarter on a reported basis compared to the prior year. The improvement this quarter is primarily related to foreign exchange, price, product mix, and unit cost improvements, partially offset by the inclusion of the lower margin legacy Abaxis portfolio.

Total adjusted operating expenses, including the impact of the Abaxis acquisition, grew 12% operationally. The increase is primarily related to the acquisition of Abaxis, an increase in certain compensation related expenses, and investments to support future growth of the business.

The adjusted effective tax rate for the quarter was 19%. The decrease from the comparable 2018 period is primarily related to discrete tax benefits recorded in the second quarter, partially offset by the impact of the Global Intangible Low-taxed Income, or GILTI tax, which was effective for Zoetis in 2019.

Adjusted net income for the quarter grew 17% operationally through a combination of revenue growth, improving gross margins, and a lower effective tax rate. Adjusted diluted EPS grew 18% operation in the quarter versus the same period in 2018.

Now moving on to guidance for the full year. As a result of our strong growth in revenue and adjusted net income in the first half of the year, we are raising and narrowing our revenue and adjusted diluted EPS guidance. Please note that guidance reflects foreign exchange rates as of late July.

I'll now walk you through each of the individual line items, beginning with revenue. We are now expecting to deliver revenue between $6.175 billion and $6.275 billion, representing 8.5% to 10% operational growth, as compared to our previous estimated range of 7.5% to 9.5%. Our organic operational revenue growth, which excludes the impact of Abaxis, is now projected to be between 5.5% and 7%. The increase in revenue guidance is related to the positive performance in our Companion Animal portfolio and, to a lesser extent, favorable foreign exchange.

We are now projecting adjusted cost of sales as a percentage of revenue to be between 30% and 31%, compared to our previous estimate of 31% to 32%. Favorability reflects the improvements in the first half of the year, which are expected to moderate in the second half of the year.

We are increasing the low and high end of the range for adjusted SG&A for the year to be between $1.505 billion and $1.545 billion, due to increased revenue estimates and promotional investments on key products, primarily the Companion Animal portfolio. As Juan Ramón mentioned, this includes an expansion of our U.S. Companion Animal field force to support current and future product launches, such as ProHeart 12, our three-way combination parasiticide for dogs, and monoclonal antibodies for chronic pain.

We are narrowing the range for R&D expense, now expected to be between $450 million and $465 million.

Full year adjusted interest and other income deductions is now expected to be approximately $190 million, compared to the previous estimate of $200 million. The additional favorability is primarily driven by a reduction of interest expense and favorable foreign exchange.

Our expectation for the full year adjusted effective tax rate is approximately 20%, compared to our initial guidance of 20% to 21%, primarily driven by the incremental tax benefits from stock based compensation and other discrete tax benefits recorded in the first half of 2019.

Adjusted net income is now expected to be in the range of $1.7 billion to $1.735 billion, representing an increase of $35 million at the high end of the range, reflecting operational increases as well as favorable foreign exchange.

Based upon our strong performance in revenue and adjusted net income, we are increasing our adjusted diluted EPS to be in the range of $3.53 to $3.60, compared to our previous guidance of $3.42 to $3.52. Our range for reported diluted EPS is also increasing, now expected to be in the range of $2.93 to $3.04 based upon operational increases and lower certain significant items.

As I've indicated in the past, we focus on full year performance, as quarterly results may fluctuate. To that end, we expect Q3 operational revenue growth to be lower than what we have seen in the first half of the year, due to Abaxis having less of an impact on growth as we lap the acquisition date. Q3 2018 included one month of revenue for International and two months for the U.S., Canada, and Latin America.

In addition, we will continue to see market challenges due to African swine fever and the weakness in the U.S. dairy and beef sectors. Growth will also be impacted by moderated price increases in the U.S., as well as the recovery of the Brazil truck drivers strike that increased revenue in Q3 2018.

Adjusted net income operational growth in Q3 will also reflect higher operating expenses, as reflected in the full year guidance, to support our current and future products, resulting in moderated income growth.

We previously communicated that we expect approximately $100 million in incremental capital expenditure this year for information technology and manufacturing to support our Abaxis acquisition, improve cost efficiencies, and increase capacity. We anticipate continuing at this elevated level for the next few years, as we invest in manufacturing and infrastructure to support future growth and product launches.

We've also repurchased approximately $300 million of Zoetis shares in the first half of the year. We have $2 billion remaining under the multiyear share repurchase plan that was approved last year and remain committed to our capital allocation priorities of internal investment, M&A, and returning excess cash to shareholders.

Our guidance for reported and adjusted earnings per share reflects the shares repurchased through the end of Q2.

Now to summarize before we move to Q&A. Our strong performance in the first half of 2019 continues to underscore the value of our diversity, innovation, and durable business model. We are confident in our revised full year guidance, where we're increasing operational growth rates for revenue and adjusted net income. And we continue to focus on long term sustainable growth by investing in our pipeline, including infrastructure, to support current and future product launches.

Now I'll hand things over to the operator to open the line for your questions. Operator?

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your line will be muted after posing your question. Thank you. Our first question comes from Kevin Ellich with Craig-Hallum. Please go ahead.

Kevin Ellich
Analyst, Craig-Hallum Capital Group LLC

Q

Good morning. Thanks for taking my questions and congrats on a nice quarter. Juan Ramón, wanted to start off with African swine fever. Appreciate the update that Glenn gave on the full year impact of $50 million. How much do you think Brazil and the EU and other market can help to offset the headwinds you're seeing in China?

And then my second question is on Simparica Trio. With the submissions in Canada, Australia, Brazil, and Japan, can you give us an update on timing for those markets, as well as kind of what you're feeling about in the EU? Thanks.

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

A

Thank you, Kevin, and let me go through the different questions that you have asked. In terms of the African swine fever, we expect a minimal impact in terms of additional revenue generated in Europe and other markets this year.

As we have explained, it will take some time to build the infrastructure to increase the number of pigs and potential export to China. We see Europe, Brazil as the main markets for this type of exportation to China. But we are not expecting a significant impact of that expansion in 2019. Definitely in 2020, 2021, it will be time for producers to expand their operations and then potentially export to China.

In terms of the submission on Simparica Trio in other markets like Brazil, Canada, Japan. Well, it's a work in progress. In Canada, we have already filed all the submission in some of the markets. We are now progressing in the submission.

And what we expect also, Simparica Trio to be approved in Europe around September, October. What we got now is the favorable opinion from the European Medicine (sic) [Medicines] (34:55) Agency. Now the European Commission is expected to approve the product in September, October. And then we expect to bring this product into the market in the first half of – in the first quarter of 2020.

Operator: And our next question comes from Jon Block with Stifel.

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

Q

Great. Thanks, guys. I'm going to put them all up front. So first, Glenn, the implied OpEx growth in the back half of 2019 is about 3.5%. And I think that's once you largely lap Abaxis and the increased investments you referenced. So is that a good growth rate to extrapolate going forward?

I guess just to push you a little bit on gross margin, your guidance implies a step down in the back part of the year. But why is that the case, considering higher margin Companion [Animal] is growing faster than Livestock? And I think that's unlikely to wind – unwind, pardon me, in the near term.

And then quickly, Juan Ramón, the filing for pain, I just want to make sure. I think that was specific to feline. Is that correct? And where would canine be in the process? Thanks, guys.

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

A

Yeah, great, Jon. So we have filed for cats. And we are in the process of filing also for dogs. We expect the product for cats, the monoclonal antibody for cats to be approved earlier than for dogs. And we expect that approval in 2021.

And Glenn will cover the questions on OpEx and the growth rate moving forward.

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

A

Yeah, so, Jon, just to start with gross margin and the step down that's implied for the second half of the year. A, first of all, in the first half there were some items that were particularly favorable in terms of foreign exchange as well as the 4% price increase that we experienced in the first half.

Also as you look to the second half, while you're correct that we would still expect the growth rate for Companion Animal to be higher in the second half of the year than Livestock, the absolute sales though for Livestock are higher in the second half of the year, just based on normal seasonality, where in the first half of 2019, we had higher sales of Companion Animal in terms of absolute sales. So those are the drivers for gross margin.

In terms of the OpEx growth, you are correct that in the second half, it would apply a deceleration in operating expense growth because of the impact of Abaxis. I'll also point that we do expect a slight change in seasonalization as well between Q3 and Q4 versus what we might have anticipated last year, with a little more expense in Q3, as I sort of implied in the prepared remarks. I would not necessarily take that as guidance for 2020 as a second half OpEx rate. Obviously, we'll provide that as appropriate once we finish out 2020 planning.

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

A

Thank you. Next question, please?

Operator: And we'll go next to Louise Chen with Cantor Fitzgerald. Please go ahead.

Louise Chen
Analyst, Cantor Fitzgerald Securities

Q

Hi. Thanks for taking my questions here. First question I had with was respect to the Nexvet portfolio. Can you give an update on the development and commercialization timelines for those products?

And then second question was on ProHeart 12. Do you still see a place in the market for this opportunity, despite the launch of the triple combo? And why or why not? Thank you.

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

A

Thank you, Louise. On the Nexvet portfolio, the monoclonal antibody that we mentioned that we have filed for cats is coming from the Nexvet portfolio. While for dogs, we have multiple programs. And we'll be really submitting or filing the best for what we think will be meeting the requirements of the market.

And in terms of ProHeart 12, definitely we see opportunities there to expand the market with ProHeart 12. Part of the sales will be cannibalizing ProHeart 6, but also at the same time gaining share in the heartworm market. And also we need to consider the opportunities of ProHeart 12 also with the future launch of the three-way combination that will be included in also the same indications of ProHeart 12 plus the protection for ticks and fleas.

Next question, please?

Operator: The next question is from Erin Wright with Credit Suisse. Please go ahead.

Erin Wilson Wright
Analyst, Credit Suisse Securities (USA) LLC

Q

Hey. Thanks. A couple questions here. So to support some of the new upcoming product launches, you mentioned you stepped up hiring activity. I guess where do you currently stand in terms of that effort? And how should we think about some of the timing related to that, as well as how quickly some of those sales reps can ramp up? And will this hiring continue into 2020?

And then my second question relates to on more of the Companion Animal side. I guess can you speak to the opportunity to leverage new relationships with Chewy and other alternative e-commerce channels? Did this meaningfully contribute to growth in the quarter? And more broadly, will this become a more significant portion of total sales that go through that channel over time? And what sort of pricing mechanisms can you deploy, whether it be price floors or otherwise? Thanks.

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

A

Well, let me start with the question on Chewy and also some other alternative channels. Definitely pet owners are also now buying animal health medicines through these new channels, mainly oral medicines for chronic treatment and parasiticides. Our products are available in these new channels but always with a veterinary prescription every time. We need a prescription product.

We definitely see this new channels expanding the market. And at the same time the opportunity also to increase compliance. So we think that this can be definitely a positive for the animal health industry. And we think that at the same time also we'll be continue working with the veterinarians to ensure that they remain at the center of any health care decisions.

In terms of the field force expansion, maybe I will provide some rationale for this expansion. And then I will ask Glenn to go into some further detail.

So just to remember that in recent years we added to our portfolio Apoquel, Cytopoint, Simparica. And all these products are reaching blockbuster sales and without any significant modification in most of the markets in terms of the field force.

Last year with the acquisition of Abaxis, we expanded our portfolio to diagnostics. We incorporated the Abaxis field force in the U.S. And in 2019, we have been also expanding diagnostic field force in International markets.

In 2019, we have continued adding new products in Companion Animal, REVOLUTION PLUS at the beginning of the year, then ProHeart 12 in July. And we've expected the launch of the three-way combination in 2020. And in 2021, monoclonal antibodies to manage pain in cats and future also in dogs. We have decided that it was needed to expand our field force in the U.S., not only in face of these new product launches but also to maximize the current portfolio that now also includes diagnostics.

And we expect to add in these additional resources in 2019 and 2020. At the same time, we are also adding additional expertise and investment in new distribution channels and also in direct to consumer programs.

Now I would like now Glenn to provide some details of these investments.

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

Yes. So, Erin, in terms of the timing for the expansion, really there are two main field force expansions that we're undergoing in 2019. One is related to Abaxis and International expansion of diagnostic specialists. And we're largely complete with that hiring as of today. So that investment has already been made. People are in place. And we expect to get increased revenue penetration in International markets with that field force now being fully operational.

The other key investment that we discussed was the increase of the Companion Animal field force in the U.S. We expect those colleagues to be largely hired by the end of 2019. And then to be fully in their new positions starting in 2020. So the majority of that investment will also be complete by the end of 2019.

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

Next question, please.

Operator: We'll go next to Michael Ryskin with Bank of America Merrill Lynch. Please go ahead.

Michael Ryskin
Analyst, Bank of America Merrill Lynch Q

Hey, guys. Thanks for taking the question. Congrats on the quarter. I got a couple really quick ones.

One is you had another quarter of really fantastic price increases, 4%, a repeat of 1Q. Coming in sort of well above historical trends. I just want to get a sense of this going forward and what's driving it. Is it tied to a higher mix of revenues? Tied to innovative products like the derm portfolio and Simparica? Or are you taking up price on some of the older generation products as well?

And then also I was hoping for a little bit more color on Abaxis. You just had some comments there on the field force expansion. But could you talk about how the portfolio is doing? Anything on competitive share shifts or anything new in the pipeline in terms of innovation there? Thanks.

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

A

I will answer Abaxis and then Glenn will read to the details of the Q2 and also the pricing. And also he will provide some comments on the Abaxis performance in Q1, Q2, and what we expect for the future.

Let me start saying that we consider 2019 for Abaxis as a year in, we are setting our self for future growth. We are expanding the field force in International markets, to make sure that we have the resources to generate future revenues.

We are also integrating the field force in the U.S. with our core field force. And is something that is already done. And we are also working to make sure that we have the connectivity with all the equipments that we – with the practice management system that we expect to finalize at the end of 2019.

We are also – we have plans that in the first quarter of 2020, we'll have also integrated all the systems. And this will facilitate the integration of the portfolio and offering much more integrated offers to our customers.

So we are convinced that we are now setting all the elements for future success. And that this will be something that will be generating growth in the future as well as growth in 2019.

Glenn, do you mind covering the additional comments on Abaxis performance and also the comments on price?

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

A

Sure. So as I mentioned in the prepared remarks, in the first half of the year, Abaxis on a pro forma basis did decline versus the same period last year. That was really driven by the fact that Abaxis had two significant product launches last year that resulted in some initial distributor stocking for both the urine sediment analyzer and the Flex4 Rapid Test.

That being said, in the second half of the year, we expect to see double digit growth for the Abaxis portfolio, as we've seen very positive leading indicators that would support those projections for the second half of the year. We're seeing less accretion in the U.S. in terms of instrument placements, also stronger instrument sales. And we believe that will lead to increased sales of consumables.

Also the fact that the International field force is now in place, we're seeing good momentum to start, beginning within our International market. So we are expecting double digit growth in Abaxis revenues for the second half of the year.

In regards to price in the first half versus the full year, so we typically expect to get price increases of around 2% to 3% in any given year. In the first half of this year, we've seen price increase of 4%. Part of that outsized price is really driven by the fact, in Q1 and Q2 of 2018 we had some promotional programs in our U.S. Companion Animal business that we did not repeat in the first half of 2019. That led to additional price.

All that being said, we still expect 2019 to be in the range of 2% to 3% but probably towards the higher end of that range.

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

A

Next question, please?

Operator: And we'll go next to John Kreger with William Blair. Please go ahead.

John Kreger
Analyst, William Blair & Co. LLC

Q

Hi. Thanks. Juan Ramón, another question on African swine fever. If you think about all the puts and takes that that outbreak is causing for the worldwide Livestock market, what is your early view on how 2020 might look relative to that 4% global number that you mentioned for this year? Thank you.

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

A

Well, we expect 2020 go back to normal growth rates. Even if the situation in China, because of the African swine fever, will be not resolved, we expect still in 2020, China continue suffering because of this outbreak. But we see other markets expanding production.

And then in terms of a comparison to 2019, we expect higher growth in Livestock and also continue with the growth for Companion Animal. So definitely we expect 2020 back to normal growth rate of 5% to 6%.

Next question, please?

Operator: Go next to David Risinger with Morgan Stanley. Please go ahead.

Thomas Chiu
Analyst, Morgan Stanley & Co. LLC

Q

Hi. Thanks for taking the questions. This is Thomas Chiu on behalf of Dave. So first question is, can you please discuss BI's triple combo NexGard SPECTRA in Europe, including its level of success? And the differentiation of Simparica Trio?

Second question is, if you could comment on other new launch opportunities over the next one to two years?

And then finally, are there any key U.S. products set to face new generic competition over the next one to two years? Thank you.

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

A

Well, as you said, we expect the new combination product in Europe competing with NexGard SPECTRA. Maybe the incidence of heartworm in Europe is much lower than in the U.S. So the resistance are completely different.

And the real opportunity for the three-way combination product is in the U.S. [ph] In where (50:25), we expect now to be first to the market, because NexGard SPECTRA or other competitors are not announcing a launch soon. So definitely, we see a significant opportunity to gain share in the U.S. Also we expect that our portfolio will be even stronger in Europe. And this also will have the opportunity to generate growth.

In terms of other opportunities in the pipeline, well, I think we are very pleased with all the product that we are now announcing. The three-way combo, Europe, the U.S., following other markets, also, Canada and Japan and

Brazil. We also expect the monoclonal antibodies for cats in Europe and the U.S. coming in 2021. And following that, we expect also monoclonal antibodies for dogs. And definitely will continue working on bringing new vaccines into the market.

So we are convinced that we have a very robust pipeline that will ensure our future growth in line or faster than the market.

Next question, please?

Operator: And we'll go next to David Westenberg with Guggenheim Securities. Please go ahead.

David Westenberg
Analyst, Guggenheim Securities
Q

Hi. Thanks for taking the question and congrats on a good quarter. So I just want to talk about the cat market. There's potential for cat Apoquel and of course pain in cats. The cat market is obviously under-medicalized compared to the dog market. What major education efforts can you maybe make? What might that look like when that investment might be, say, in place? And just overall, how do you expect to increase that medicalization market in education, not just in terms of the products but veterinarian education?

And then a second question on ProHeart 12. We had great feedback at AVMA. Basically, they talked about compliance, one-year injection. Much better than I actually anticipated with ProHeart reception. Is there any fear in kind of cannibalization with this? I understand that ProHeart is just ProHeart, and the triple is going to have worms. But just kind of think about the dynamics for potential cannibalization there. Thank you very much.

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

Thank you for the question, Dave. So basically the cat market, it's a market that we need to develop. But pain exists in cats, and it's something that today there are not valid solutions to manage pain in cats.

We know that there are two element that we need to consider. First, the number of cats is lower than dogs. And also the number of medicalized cats is lower than the number of medicalized dogs.

But having said that, we expect the monoclonal antibody for cats becoming a blockbuster for Zoetis. It will take maybe some years to fully develop the market. But we are convinced that we'll be bringing unmet need. And the opportunity will be significant.

We expect in terms of the ProHeart 12 cannibalization from ProHeart 6. But what we see is that now, Zoetis will be offering to the veterinarians all range of solutions for ticks, fleas, and internal parasiticides (sic) [parasite]. And will be for veterinarians also to decide what is the best for their dogs to use ProHeart 12 in combination with Simparica, to use the three-way combination product or what they think is the best for protecting the animals.

So even if there will be cannibalization, I think here what we need to consider is what will be the opportunity of this complete portfolio in terms of parasiticides.

Next question, please.

Operator: We'll go next to Chris Schott with JPMorgan. Please go ahead.

Chris Schott
Analyst, JPMorgan Securities LLC

Q

Great. Thanks very much for the questions. Just two here. Maybe first just coming back to margin trends and the SG&A investment you're making. Should we think about OpEx growth below sales growth in 2020 and beyond? Or with some of these initiatives that you're investing in, could we see a year in 2020 where spend looks a little bit more in line with sales growth, as we think about kind of just the progression over the next few years?

And my second question was on Simparica Trio. I guess at this point, how much of a lead do you expect you'll have in the U.S. market before you see additional competition? And how much of a lead do you think you need to really impact share, as we think about how the different players line up in the market? Thanks very much.

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

A

And I will respond to your question. And then Glenn will cover the margin trends and also the expenses that we will be seeing in future years.

And in terms of Trio, as you know, Chris, in our industry there is not too much visibility in terms of the progress that our competitors are making in their pipelines. We know that in the U.S., FDA is requiring 100% protection against heartworm. And we know that so far it seems that the three-way combination of Zoetis is the only one showing this type of efficacy.

Other competitors, maybe they will be also facing some challenge because they have the products protecting against the ticks and fleas for two or three month and then heartworm with one month. And then combining the product with different timing also can be challenging. The timing of competition it's unknown to us. But we are confident that being the first to market will represent an opportunity to gain share in the parasiticide segment. Glenn?

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

A

In terms of the investments that we're making in the field force, first, I just want to say that these are very positive investments that have a very strong return. To be investing in field force to support existing products that are exceeding our expectations and a significant number of new products that are going to be coming out in the future. Those are very high return investments. So we would expect those to be margin accretive over time as we move into 2020.

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

A

Next question, please.

Operator: Next is Liav Abraham with Citi. Please go ahead.

Liav Abraham
Analyst, Citigroup Global Markets, Inc.

Q

Good morning. Just a follow-on question on your three-way combination parasiticide. Juan Ramón, any preliminary thoughts on what the launch curve could look like, particularly in the U.S., of this product? And how quickly the uptick – how quick the uptick could be?

And then secondly, interested in some additional comments on the poultry market. You cited this as a contributor to growth in your Livestock segment in the quarter. Interested in your longer term outlook for poultry and some of the drivers behind this. Thank you.

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

A

Thanks, Liav. So on the three-way combination products, it's probably a little bit too early to define the uptake. First, we need to ensure that we have clarity on the label. And this is something that is still a work in progress. One, we have the label.

And then we also have the exact timing of the launch. We will provide maybe how much we expect adoption of this new product into the market. And the different launching in January, then February or March, so and it's something that still we don't have certainty of the timing of the launch. And also we need to still get the approval of the final label.

Poultry, it's an area that has been performing extremely well for Zoetis. We expect that poultry will continue – as a market segment will be continue growing faster than the average of the animal health industry. And we'll be growing in line with this growth.

For us, poultry, it's an area in where we are investing also in R&D. And we expect to bring new products into the market starting in 2020. That will be new vaccines with the vector technology that initially will be introduced in the U.S. and then later in European markets and other International countries.

And definitely it will be shortage of pork availability in the world. And as we see the consumption of animal proteins continue growing, consumers, they will need to move maybe to more chicken, even more beef and maybe – well, at least in some countries like China, some limitations in terms of pork consumption. But definitely poultry is an area of investment.

We have very strong portfolio of vaccines. And again, so we'll be planning to launch vector vaccines in 2020 or 2021.

And finally, we are also combining our presence with the medicated feed additives, with vaccines also with a very strong portfolio in terms of devices. We have the injectors, which is something that is adding significant value in the hatchery and other segments of poultry. And we also introduced products for automation in 2018 and 2019.

Next question?

Operator: Next is Kathy Miner with Cowen & Company. Please go ahead.

Kathy Miner
Analyst, Cowen and Company, LLC

Q

Thank you. Good morning. Couple questions. First, maybe, Glenn, could you give us some Apoquel sales for the U.S. versus o-U.S. this quarter?

And on African swine fever, could you also tell us what the second quarter impact was? And if there's any update on the vaccines that you're working on for the swine fever?

And then finally, just a bigger picture question. I wonder if we could get your thoughts on some of the U.S.-China trade discussions. Understand it's very volatile, but what are some of the possible impacts or situations you're looking for that could be impacting Zoetis? Thank you.

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

A

Let's answer the question on Apoquel, then we'll move to African swine fever. And...

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

A

Yeah, so just for the numbers for Apoquel. So I'll start with total derm, just to give the overall total derm breakout between U.S. and International. So total derm globally, we had $182 million, $127 million within the U.S., $55 million in International.

And for Apoquel we had total global sales of $133 million, in the U.S., $87 million, and International, $45 million. Obviously, there's some rounding there.

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

A

And the impact of African swine fever?

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

A

The impact of African swine fever in the quarter was a little over $10 million for the quarter.

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

A

Okay. So then in terms of the update of the African swine fever, we expect that there will be some opportunities for other markets to supply to China. We also expect that – well, we are not expecting a new vaccine for African swine fever soon. But we are working on developing this vaccine in collaboration with the U.S. and other International centers.

And in terms of trade, well, we see trade impacting agriculture in the U.S. We have seen also that China will not be buying pork from the U.S. But it's also true that they will be buying from other markets. And maybe other markets also will be buying from the U.S.

So we are not at this point too much concerned about the impact of the trade in the pork industry. The pork industry has been very limited in terms of exportations to China. I think it's something that is less than 20% of the total exportations of pork to International markets to China.

So definitely it's an impact, but it's an impact which is manageable. But we expect and we hope that finally the U.S. and China will find an agreement that will eliminate all this attentions.

Next question, please.

Operator: Next is Navin Jacob with UBS. Please go ahead.

Prakhar Agrawal
Analyst, UBS Securities LLC

Q

Hi. This is Prakhar Agrawal on behalf of Navin Jacob. My first question is on gross margin. So you had previously guided on gross margin expansion of 200 basis points from 2017 to 2020. And you're obviously tracking significantly ahead of that guidance already, despite Abaxis. So just wondering if there is an update to that guidance? And is it possible to get greater than 70% gross margin over the next three to five years?

And secondly, on the macro trends in U.S. cattle, could you provide more color on some of the trends that you are seeing? You had highlighted continued weakness in dairy and beef cattle. But when do you expect recovery in these segments? Thank you.

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

A

So let's start with the gross margin, Glenn.

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

A

In terms of gross margin, the 200 basis point improvement that we referenced from 2017, that was driven by the operational efficiency initiatives and some changes in our supply network that we were initiating. We are on track for that and expect to deliver the 200 basis points.

At that time, we said there'd be other factors that could either positively or negatively impact gross margin over that same period. Those factors being price, mix, foreign exchange. Many of those have moved favorable for us, particularly this year.

And those factors will vary year over year. So I wouldn't necessarily take some of the benefits that we've gotten this year from price, mix, and foreign exchange necessarily to carry over into the future years. But we are well on track for the 200 basis point improvement that we've targeted as part of the operational efficiency initiative. And some of the other factors have been beneficial for us in 2019.

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

A

And about the macro trends in the U.S. for cattle, we are expecting dairy prices to increase in the second half. We will probably take longer. So we continue seeing weaknesses in the dairy business coming forward. It will be something that over time will be adjusted. Now they will be adjusting production. And then in the next cycle, prices will be increasing and the opportunity for again dairy expansion.

In terms of beef in the U.S., there are two element that has been impacting the performance. And first, has been the weather, very cold winter. And then second, a very wet spring. And this has been delaying the movement of animals from pasture to the feed lot.

And they're moving animals which are heavier. Heavier animals also are stronger in terms of protection against diseases. And we see that the cattle market, the beef cattle market in there has been slower than expected. We expect some recovery in the second half, although we expect that in the U.S., the cattle will be showing very modest growth. And Zoetis will be growing in line with this growth.

Next question?

Operator: And today's last question is a follow up from Kevin Ellich with Craig-Hallum. Please go ahead.

Kevin Ellich
Analyst, Craig-Hallum Capital Group LLC

Q

Hey, guys. Just really quick. Juan Ramón, wanted to get your thoughts on the alternative protein market, the plant based market. Do you think that'll have any impact on the Livestock production market over the next 3, 5, 10 years?

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

A

I don't believe that this will have an impact. The growth of the population, they increase on the middle class. It's increasing there so much as a demand that it will be needed many different sources of feeding the population to meet that demand.

And this will be, as we have seen in other cases, an alternative for people that prefer not to eat animal proteins. But still the demand for the consumption of poultry, chicken, beef, eggs, dairy will remain very strong, and I will also add fish to this list.

So I don't expect that the animal health industry will be impacted because of this alternative. But this will – definitely will offer to consumers options for their diet, which in my opinion is always a positive.

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

So thank you very much for joining us today. And, well, as I said, we had a very strong quarter. We have also increased our guidance, which is showing the confidence that we have in the performance of our portfolio. And additionally, we also shared with you the good news of our pipeline and how this pipeline will be reaching the market in the next coming years. Thank you very much for your attention.

Operator: And this does conclude the Zoetis Second Quarter 2019 Earnings Call. You may now disconnect.