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Zoetis, Inc. (ZTS)

Bank of America Merrill Lynch Animal Health Summit

CORPORATE PARTICIPANTS

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

MANAGEMENT DISCUSSION SECTION

Unverified Participant

Thanks again for being at the Bank of America Merill Lynch 2018 Animal Health Summit. Our next presenter is – I know they're not doing an extra presentation in the fireside chat so no; you're going to do 30 minutes. So we have Glenn David, CFO from Zoetis, up here. And so we're just going to have a fireside chat and we'll open up for questions, and we'll do it like that. So [ph] Mike (00:00:24) and I will run the questions.

Thanks, Glenn, for being here. We sincerely appreciate you making the trip from New Jersey. So I was reading the transcript from the call again, the fourth quarter 2017 call, and I was sort of flashing back to the fourth quarter 2016 and the first quarter 2017 call. And the people initially were – they didn't think the initial 2017 guide was strong enough. And then in Q1, the gross – nobody – people didn't model the gross margin correctly and you ended up certainly better on the margin, better than on the top line, clearly much better like that. So can you talk about – just do a little bit of a rehash of 2017 and sort of like bring us up-to-date on everything and then we'll kick it off from there.

Glenn David

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

Sounds good, and thanks for having us. So in terms of 2017, 2017 was a very strong year for Zoetis. As you mentioned, at the beginning of the year I think there was some concern on the margin progression. We talked about our guidance for cost of goods in that 32% to 33% cost of goods range, and then we started out the year higher. And that was for clear reasons that we articulated, but I think people needed to see if we delivered throughout the year which we obviously were able to execute.

When you look at the overall performance for 2017 from a revenue perspective, I mean, we're able to deliver 8% operational revenue growth even with some of the negative impacts that we had from our SKU product rationalization as well as the impact of the Veterinary Feed Directive trial performance in 2017. It's a really strong performance and balanced performance as well.

Overall, livestock business grew about 5% even with slow performance in the U.S. because of the VFD, and we had very strong performance in our companion animal business, growing 14% with the continued performance of APOQUEL, of CYTOPOINT, of SIMPARICA as well as many other vaccines that we launched. Also, we got continued strong performance from Brazil and China not just in the livestock segment but also in the companion animal segment, really seeing the benefit in medicalization rates increasing in those markets. So overall, just a very positive year in 2017.

QUESTION AND ANSWER SECTION

Q

So with that end, can you sort of talk us through what are sort of the drivers as you head into 2018? Can you walk – you guided to 5% to 7% on the top line for constant currency growth. Can you talk about what the drivers are to sort of get there particularly as you're coming up against some particularly difficult comps in the companion animal space?

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

A

All right. So if you look at the growth for 2018 in the 5% to 7% range, it's consistent with our long-term value proposition of growing revenue faster than the overall market or rather faster than (sic) [or in-line with] the overall market. So we see about 1% to 2% coming from price as we typically would, probably about 1% to 2% coming from our in-line volume, and then the remainder coming from the new products. And when we say new products, that also does include APOQUEL in derm, but those products have been on the market for a little bit. But we do expect to get continued growth from APOQUEL, from CYTOPOINT, from SIMPARICA. However, we don't expect the growth to contribute as much as it did...

Q

Right.

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

A

...in previous years because we've established a new baseline for those products, delivering $428 million in revenue for those products in 2017.

Q

So when you look at the 5 number or the 7 number, like what are sort of like the pluses and minuses sort of butchering that different range?

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

A

Yeah. When you look at a range of 5% to 7%, A, the range is pretty narrow to begin with. So for us, that's about $125 million range which is plus or minus $62.5 million on either end. So there are a number of factors that can throw us to the high end of that or to the low end of that. That can be performance in our livestock business in terms of health of the animals. Are we getting lighter animals, are we getting heavier animals that are more prone to sickness or not? We continue the advancement that we'll see in our new products, the continued advancement, the magnitude that we'll see on our dermatology portfolio. Those are some things that, if they go on the positive direction, will lead more towards the 7%; if they go on the negative direction, it could lead us more towards the

5%. But overall, the fact that our business is that predictable and durable and reliable I think is a very good sign, sitting at this part of the year, that we have strong confidence in that 5% to 7% revenue growth.

Q

And on the core companion animal business, I mean, if you exclude the CYTOPOINT, APOQUEL, and SIMPARICA, I mean, one of the questions we continually get from investors is like that has been more of a low single-digit sort of growth core business. The question becomes on what are some of the new product opportunities in companion animals to sort of drive that further and sort of like how do you see that core or how do you – I guess how do you see the core expanding and what are the new products that sort of drive further growth in companion animals?

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

A

Sure. When we look at the growth in companion animal, I think there are a number of things that will continue to drive it. So, A, it's hard whether or not APOQUEL is part of the core business or not at this point.

Q

Right.

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

A

The product launched a number of years ago, so I think we'll continue to get growth from APOQUEL. We'll continue to get growth from CYTOPOINT. We'll continue to get growth from SIMPARICA. Some of the other areas that we're excited about as we look out a little bit is obviously additional combinations with SIMPARICA we think will drive further growth. We continue also to get growth from the new vaccines that we introduced. And then you have to look to the emerging markets as well. So we saw very strong performance in Brazil, very strong performance in China, and a lot of that was driven by investments that we made early on in those markets. So we talked previously about how we've increased our field force size for companion animal in Brazil and China as we saw the trends of the increasing medicalization rates and our ability to introduce additional products in those markets, and that benefited us. And we expect that to continue to benefit us moving forward.

Q

And then the growth in the emerging markets you're talking about, is that for the core portfolio or is that from CYTOPOINT, expanding OUS?

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

A

It's a combination. So the majority of it is the core portfolio. So particularly in China, it's the core portfolio that's performing well. And then in Brazil, it's the core portfolio as well as additional contributions. Brazil has performed very well with SIMPARICA and is also growing with APOQUEL as well.

Q

And since CYTOPOINT has been largely U.S. so far, we do think of it as different in terms of chronic versus acute versus APOQUEL. But then now that we have a few years of APOQUEL U.S. versus OUS performance, how do you think about the CYTOPOINT domestic versus international market opportunity?

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

A

No, and it's a good point. So I think there are different areas of growth that we're going to see in the dermatology portfolio based on the geography and the timing of the launches. So I think when you start with APOQUEL, I think we still have upside for APOQUEL in both the U.S. and international; U.S. expanding more into some of the acute patients as well as the seasonal, and also we believe we still have additional price to capture in the U.S. CYTOPOINT is also relatively new in the U.S., and we think we'll continue to grow well. Outside of the U.S. as you mentioned, CYTOPOINT just launched in the second half of 2017, so we think we still are on that launch curve with CYTOPOINT to drive growth moving forward. And when you look at APOQUEL internationally, it hasn't had the same penetration yet that we've experienced in the U.S., so we do see additional opportunity for APOQUEL as well internationally.

Q

So sort of taking all that together, again as you said, $428 million derm portfolio, fantastic results. But in my mind, that sort of leaves $500 million for 2018 as a bit conservative. Is there anything you're seeing in the market? And I realized you've raised it from $300 million to $400 million to $500 million, but that kind of leaves me to say, okay, why not $600 million, why not $700 million?

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

A

Yeah. So the guidance that we provided for 2018 for our derm portfolio was to exceed $500 million, which still is significant growth off of the $428 million that we experienced in 2017, with one of the products being on the market for a number of years now in APOQUEL. That being said, we do expect additional growth opportunities for those products over the long-term. But for 2018, the guidance that we believe is in excess of $500 million.

Q

Staying with the companion animal space, can you talk a little bit about the SIMPARICA ramp and just sort of its competitive position with other products and sort of expanding that one going forward?

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

A

Absolutely. So for SIMPARICA, we saw about $92 million in sales in 2017, so a significant ramp over 2016 and in line with what we expect the product on a stand-alone basis to be in terms of a blockbuster in animal health, which is greater than $100 million. What we're really excited about with SIMPARICA, and where we think the additional growth will come, is with additional combination products for SIMPARICA, and that's really where our focus is from an R&D perspective with those products.

Q

And what's going on in terms of the vets? I mean, obviously, to do SIMPARICA and to get their orals, they need prescriptions. The owner has to go to the vet to get the prescription with it. Has there been a – I'm just curious, what sort of is the market share between the orals and the topicals right now, and just how many vets are prescribing orals? I don't have any prescriptional market data on the...

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

A

Yeah. I don't have specific percentages but I think what you're seeing is probably, when you take all categories including OTC as well as what's prescribed in the vets, the topicals are still larger in the market. But we're seeing a significant increase in the orals; and their penetration, they're growing much more rapidly. And SIMPARICA has been able to take share from other orals as well as from some of the other topicals as well, so we do see that the orals are gaining a lot of share and gaining it rapidly.

Q

I mean it's – just as an interesting note. We finally moved my dog, which I'm going to mention my dog a lot today so just get used to it. So we moved [ph] Kiki (00:10:16) off of frontline because my girlfriend actually had an allergic reaction to it as a topical, so she's on an oral right now. But I just – when these things – we couldn't figure out why she was – we couldn't figure out what's going on and we sort of realized you're allergic to that. So I...

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

A

We definitely do see the oral administration as being a superior way to administer, and we do see rapid transition to that class.

Q

[ph] Mike (00:10:46), any more companion animal questions?

Q

No. I mean, you want to move on to livestock?

Q

Yeah, let's talk livestock. So when we were doing due diligence prior to launching back in the summer of 2016, there was a lot of debate about the medicated feed additive and sort of like the Veterinary Directive. You had said that you felt that your exposure at that time was around $50 million, like that. I think you called out last year that it was about a $40 million headwind to the business, so pretty good estimate of what the business is. Is there any more downside potential risks of that? Just sort of talk about how – what you're doing in terms of nutritional supplements and sort of other things that sort of go through that.

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

A

So I think it's important just to put our overall medicated feed additive business in perspective and then [Technical Difficulty] (11:34) to additional risks that there may be there. So overall, we have about $500 million in medicated feed additives. Only about half of that actually contains antibiotics, so that's about $250 million or so. And the others are alternatives that we've actually seen some positive growth particularly in poultry as the producers there look and switch to no antibiotics ever. So we've seen very good growth in some of those products, particularly in the U.S. So then of that $250 million, that's probably what you could consider at risk and where the VFD had somewhat of an impact as well this year. So we had about a $40 million impact this year related to the VFD, and we think that's stable, right? We don't expect that to increase as we move into 2018, so we don't expect the VFD to be a negative impact to growth as we move into 2018.

Q

And I guess we need – it's interesting on the no antibiotics ever in the poultry market because obviously that's been – I mean, you sort of look at the charts in terms of how the production of poultry and sort of like the size increases. Since they've gone to this, is there any change in sort of the weights of the birds that are sort of coming out of the markets right now or coming out of the producers? I mean, are they still getting sort of like yields in terms of – basically I'm just wondering if there's any noticeable difference in terms of the production now they're sort of going off of this antibiotic usage.

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

A

Yeah. No, so we don't see that there's been a noticeable change in the production. I think part of that is just the lifecycle of the animal poultry is more apt to go to no antibiotics ever just because I believe it's about a 42-day lifecycle whereas when you step up to swine and then you step up to cattle with their much longer lifecycles which makes the transition much more difficult and challenging.

Q

All right. And then Europe has implemented a lot of these regulations. There's a lot of the same consumer sentiment, but that's several years ahead of the U.S. So is that sort of the model you're looking forward in terms of what's this going to develop or how is the U.S. different versus what you've seen in Europe? And then also, we don't think that this is a risk for the rest of the world in terms of China and Brazil, but have you heard any concerns there? Is there something that's sort of stabilized for now?

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

A

So we think the market is relatively stable, right? As you mentioned, Europe, a lot of the current legislation is already in place and we don't see that changing significantly. There may be some markets that put additional restrictions and perhaps even extending to companion animals; we see that to some degree. In terms of the U.S., we saw the implementation of the VFD. We haven't heard anything additional or significant different than that for the U.S. And then in some of the emerging markets, we haven't seen anything necessarily changing there as well. And as the emerging markets become more industrialized, we see opportunities overall for our products in those markets beyond just the MFAs. So when we look at the MFAs overall, while we don't expect them to grow at the overall pace of the animal health market, we do expect them to grow but in the lower single digits.

Q

And that's even in 2018?

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

A

That's even in 2018.

Q

I think we've been surprised that the herd sizes in the United States continue to be so strong given you're coming off of the drought for a few years ago. I think the numbers are still really good, good place with animals on the feedlots [indiscernible] (00:14:51). How do you sort of think about the U.S. livestock market in 2018? I know you're talking about a general pickup in it. But sort of what are you tracking and what are you looking to give you confidence that it's going to continue to grow?

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

A

In terms of the U.S. livestock market, there are a number of factors that impact our performance. A, number of animals. Always more animals is better, but one of the key factors for us is what is the health of the animals as they move into the feedlots. Are they coming in lighter, were there more susceptible to disease, and therefore will be using more of our products; or are they coming in heavier, healthier, where they won't need as many of our products. And that's always somewhat up in the areas we moved around the year based on weather conditions. So more animals is always a positive. But until you see what the weather conditions are and the health of those animals coming in to the feedlots, it's hard to determine exactly what the outlook is going to be.

I think we closed off 2017 very positively in terms of the U.S. livestock business. We see some of those trends continuing as we move into 2018. But the second half of 2018 will be determined based on the health of the animals as they move into the feedlots in the second half of the year.

Q

One of the questions that I get from when I go marketing in Europe and I talk about Zoetis, in particular I get a lot of pushback in terms of the sustainability of livestock, and certainly cattle are big on the – they're talking about their carbon footprint and is it really the best use of land, right? So there's lot of SRI funds that sort of focus on this. You've obviously moved into aquaculture like that. So can you talk about just sort of how you're looking at global protein growth in terms of animals versus livestock versus fish and just sort of thinking about your strategy in this market in sort of dealing with the fact that in China and in some of the other emerging markets that's less of a beef market and they're poultry guys just your general OUS strategy like that? Sorry, a very convoluted question.

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

A

No. I mean, I think just generally globally, right, we see the demand for protein increasing, right? And that definitely is a factor particularly as you look to the emerging markets and outside of the U.S. as well. And I think when you look at Zoetis, we cover all sources of protein, right? We have a full portfolio for all species. And you mentioned the aquaculture and our entry there with the with the PHARMAQ acquisition. So we really are focused on making sure that we're covering all the key sources of protein and that we're a relative competitor in all of those markets. And I think we demonstrated really good performance with the PHARMAQ acquisition as well, particularly when you look at our performance in 2017 and what we're able to deliver in the second half of the year, in particular where we grew almost 40% in that business. But we're really trying to make sure that we're balanced across portfolios in terms of species as well as balanced across the portfolio in terms of therapeutic areas as well so that we can meet the needs of the population and the growth in the protein consumption.

Q

So you're not worried about longer-term trends in terms of protein consumption in livestock and cattle and...?

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

A

Not in terms of overall trends, again because in every market we have meat alternatives as well. So if there's a switch in protein consumption from beef to swine, we have strong products in swine. If there's a switch to poultry, we have strong products in poultry, and same thing with fish.

Q

Well we've beaten the markets here. So since you're a CFO, let's talk a little bit more financial. You've had phenomenal margin expansion in the business over the last few years. Just I think it's surprising a lot of people in terms of what you've been able to deliver. A question we often get from investors is like they're pushing 34%, 33% operating margins. Where do they go? It's like how do they sort of balance the growth versus sort of like dropping it down at the bottom line. So just curious in terms of where you see the margins and sort of how you're investing in the business.

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

A

Absolutely. I think one thing to point out, though, in terms of the improvement that we've seen in margins. So we've talked about in 2015 that we expected to deliver 34% in margin in 2017, and we delivered that. We delivered that well and our team really executed effectively against the operational efficiency initiative. I think what's most impressive about that, though, is you still saw the revenue growth, right? And that I think is a lot of the concern when you see people just focused on margin, are you going to deliver your revenue. Our teams have been able to successfully deliver innovation as well as our commercial capabilities to deliver the revenue growth as well. And I think that's why what you hear us say is we're not focused solely on the margin. We're focused on making sure that we drive revenue growth and that we continue to drive income growth faster than revenue.

Now that being said, we do have opportunity for additional margin expansion. We've talked about in the past that we expect to get about 200-basis point improvement in gross margin out of our supply network strategy by 2020 when we are on track to achieve that. And depending on price, volume, and mix, there may be some additional opportunities there from a gross margin perspective. And we also continue to be committed to growing our revenue at a pace faster than our expenses, so that should drive margin expansion as well. But we are going to make the investments that we need to make sure that we can continue to support that revenue growth. And I think you saw that a little bit this year in terms of the 2018 guidance where our R&D expenses are sort of above that inflationary level because we see a lot of good opportunities within our R&D portfolio. We've been very productive with our R&D portfolio and we want to make sure that we continue to support not only short-term revenue growth but also medium and long-term revenue growth.

Q

So touching on that, on the R&D side.

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

A

Sure.

Q

I understand there's a broad base of the business but it still comes back to the individual products. There's so much focus on APOQUEL and CYTOPOINT. You talked about some opportunities with combination therapy for SIMPARICA. What else is there that sticks out to you? And this is a question I came up earlier in the prior panel of where is there unmet need in animal health, what are the big markets that you're not attacking yet.

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

A

So from an R&D perspective, A, we've been very fortunate over the last number of years. We've had tremendous productivity in our companion animal portfolio with APOQUEL, with CYTOPOINT, with SIMPARICA. That being said, our R&D investment is spread pretty evenly across all of our species and therapeutic areas to some degree as well. So some of the areas that we're excited about, we continue to be excited about vaccines and what additional new vaccines we can introduce to the market in both companion and livestock. We're also very excited about our capabilities with monoclonal antibodies and how we could extend that to other areas such as pain, for example. And as you mentioned, we also continue to be excited about our SIMPARICA product and additional combinations and what we could deliver there to the marketplace.

Q

And can you give an update on the Nexvet deal that's been a few quarters since that closed? How's the progression and any update on any of those products?

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

A

Yeah. So from the Nexvet deal, we're still working with the products that we acquired from Nexvet. We don't disclose specific timelines. We've been pretty consistent on that so that's something that we'll continue. Just from a competitor perspective, we don't see the benefit of disclosing the timelines.

Q

And remind us the lead products in the Nextvet pipeline were what?

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

A

I forgot the exact NV, but the lead product was a monoclonal antibody for pain and that's something that we continue to work. I forgot the exact...

Q

Just going on the R&D investment, you've talked for a while about expanding your footprint in diagnostics. You recently launched the Carysta HVC instrument which was debuted at VMX with that relationship. Can you talk a little bit more about that business and sort of diagnostics in general and sort of how your view of that world is where you're going to play?

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

A

Yeah. So we see diagnostics as very complementary to our overall portfolio, and that's an area that – with the acquisition that we did with SMB or Scandinavian Micro Biodevices – we think we acquired a pipeline that we could really build internally and bring to the marketplace. So we're currently in the process of building our commercial capabilities in that space with more technical focus on diagnostics but then being also able to leverage our current internal field force for lead generation. So that's an area that we're excited about. We think it's complementary to our business, and we think with the R&D pipeline that we acquired from SMB we can grow organically at this point.

Q

And so are you placing the HVC instrument this quarter already? And then is it a U.S.-only roll out versus international?

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

A

So I believe at this point it's focused on the U.S. and it's going to be launched in the first half of the year in terms of placements.

Q

And how does it position relative to the IDEXX and Abaxis and Heska portfolios?

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

A

So we think this addresses an uncertain market (sic) [unmet need]. It's a relatively niche market. But in terms of the high-volume, larger machines, we believe this will address an uncertain market (sic) [unmet need].

Q

I mean, when I sort of think about that from talking with IDEXX and talking with [ph] Wolfe (00:23:49) in the past, I mean, it's that it's the market where you certainly have a lot of Siemens and Roche and those instruments. It's less than going exactly against the Abaxis and IDEXX and it's more against going to these human platforms which are being put in higher throughput labs and sort of optimized for animal health.

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

A

Correct.

Q

It's that niche of the market rather than going head-to-head in the point of care and some of this other stuff with the other companies?

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

A

Correct.

Q

Great, great. Do you intend to go into the point of care and go head-to-head with these, well, more entrenched competitors?

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

A

With what we've acquired from SMB and with the R&D that we have there, we do believe we'll have good products that will be able to compete in those markets.

Q

And you're doing – I have to ask this from my human diagnostic standpoint, but any opportunity for companion diagnostics as you sort of think about it because since you're doing monoclonal antibodies? You're doing so many things there. Is there any need for that in the animal health space in terms of looking at – you've got this drug. Should you give this drug to your pet or is that even not a conversation that you're even getting?

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

A

No, it's definitely a conversation. We think that's where some of the complementary aspects of diagnostics plays with us. So when we look at our overall continuum of care, where we see diagnostics playing is in terms of detection, right, because to the extent that you could detect what the illness is and then we have the treatment as well, that's really where we see a nice overlap and a nice synergy between the two. So to the extent that we could detect a disease or that we specifically have a unique product for, that we think will be very complementary to our business.

Q

The business was a big beneficiary of tax reform. The tax rate dropped down significantly. Can you talk a little bit more about capital deployment in terms of share buybacks, how you're thinking about it? I mean, the company is – the net leverage I think is well below 2x at this point. So can you just sort of talk about it?

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

A

Yeah. So as you mentioned, we were a beneficiary of tax reform. Our tax rate in 2017 was about 28%. With tax reform, we're about 21% to 22%, so that definitely increases our cash generation. In terms of our allocation priorities, the priorities for capital allocation haven't changed. We continue to focus internally in terms of manufacturing R&D and commercial investments. And you saw us generate positive returns on that in 2017 in areas such as the DTC for APOQUEL and SIMPARICA and some of the manufacturing investments and R&D investments we've made as well. We'll then look for business development opportunities, right, as our second priority is to continue to leverage the infrastructure that we have and grow additional assets. And then we'll return the remaining capital to shareholders in the form of dividends and share repurchase. We recently increased our dividend by about 20%, but our preferred form of returning excess capital to shareholders is via share repurchase because that gives us a little additional flexibility to execute on our internal priorities as well as business development. And with tax reform, we have more flexibility to execute on those priorities. So we're very excited about the additional cash and the opportunities that it's going to provide us.

Q

You mentioned that some policies were bouncing around, but that's the way it work. So I've seen the DTC ads.

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

A

Yeah.

Q

Can you talk about how much those cost on average and sort of like how you measure the return on that? I mean, how successful are those in dropping business?

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

A

Excellent. So we haven't spoken specifically about the amount of investment we've made in DTC; we haven't disclosed that. In terms of the evaluation that we do, we do typical ROI analysis to see the return that we're getting from the investments. And we're very pleased with the returns that we got particularly with APOQUEL and the growth that you saw in the U.S. in APOQUEL in 2017 as well as SIMPARICA – growing the base of that product – that we think it's going to be an important platform for us as we move forward. So we've measured those returns on an ongoing basis. They've been positive for us and we'll look to continue those investments as we move forward.

Q

Is there any opportunity to expand that to additional drugs or is that on a case-by-case basis? I mean, I realize that APOQUEL and SIMPARICA are sort of unique opportunities to gain share, but...?

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

A

Yeah. We definitely evaluate that on a case-by-case basis to make sure that the products warrant the DTC and will drive the right return. And with APOQUEL, for us, given the size of the product and also the fact that we think there is opportunity to continue to expand in the market. And since we are clearly the leader in that space with APOQUEL and CYTOPOINT, we believe that we can get somebody into the vet's office asking for a atopic dermatitis product, they're going to walk out with either APOQUEL or CYTOPOINT. So they really lend themselves very well to DTC.

Q

Is there any chance of expanding that OUS for APOQUEL or are those markets too immature?

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

A

Well there's different restrictions outside of the U.S. from a DTC perspective in terms of markets where you're allowed to do DTC or markets where you're not. So for example, in Brazil we have DTC for SIMPARICA. In Australia, I believe you're allowed as well, and we have some DTC there. But most of the markets outside of the U.S., you're not allowed to do direct-to-consumer advertising.

Q

And you talked about – when you're talking about cash generation and how you're going be spending, you talk about the incremental spend internally. We've talked on R&D and the gross margins a little bit. But on SG&A, there's also the expansion in the SG&A to support the diagnostics portfolio as you said. Is there also expansion elsewhere in the portfolio, both livestock or companion, the core product, DTC? Can you sort of break up where the incremental SG&A spend is going in 2018?

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

A

So I think when you look at the SG&A spend, there's a number of things that you need to consider. A, we're committed to making sure that we focus the majority of our SG&A spend on things that are going to be driving revenue. So what that means is internally we're always looking at ways to be more efficient in those areas that are not directly driving revenue. So when you look at the overall growth, we're always working internally and say okay, what areas that are driving revenue can we grow faster, so therefore what areas that aren't driving revenue could get additional efficiencies so that overall we're able to grow that SG&A more in line with inflation and support things such as the diagnostic build that we were going to fund in 2018.

Q

And along the lines of SG&A in the U.S., can you review both for companion and livestock and for diagnostics sort of what your relationship is with the major distributors? If I'm a vet and we're going to have some later on and I'm ordering a Zoetis product, what's sort of the flow to market?

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

A

So if you're a companion animal vet in the U.S. and you're looking to order Zoetis products, you have a number of options. So A, if you're looking to order products like APOQUEL or CYTOPOINT that are a little more technical and differentiated, you'll order those directly through us; they're only available through us. In general though, if you're looking to be able to order all of your products together from multiple providers, you can do that as well. I think the key thing to note though for us, we believe that the key colleagues out there generating demand for all of our products, regardless whether it's going to be distributed through a distributor or directly from us, is our field force. So we believe we have the best-in-class field force and they're out there generating the majority of demand for all of our products

Q

Obviously, we've gotten a lot of questions about potential disruption by non-traditional players, the big A-word on sort of like the drug distributors and stuff. I guess sort of how do you look at the threat from the Amazons of the world and just sort of people trying to come at this? And this is going to lead on to the generics question after this one obviously, but can you first talk about both of those points?

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

A

Yeah. So from a Zoetis perspective, we don't see necessarily an immediate threat for a couple of reasons. A, our products are focused through the veterinarian, so we are not very present in the OTC space which we think is more apt for that type of transition. The other thing that you need to consider from a companion animal perspective is many of the products are administered in the vet's office, so the vaccines are administered in the vet's office which also limits the opportunity there to a large degree. So for us, we really don't see that as an immediate threat. Could it be a threat in the long-term? Absolutely. But in terms of the short-term, we don't really see that as a major threat for Zoetis.

Q

And when I do teach ins on animal health to investors [indiscernible] (00:32:34), it always seems that whenever there's a new analyst that joins the firm – life sciences tools and animal health are where they throw the newbies in terms of this, and so we get a lot of these teach ins just like, well, what's in that stack. And on the animal health, it's like they often just sort of like can't deal with the fact that generic risk is not there.

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

A

Yeah.

Q

And we go back and forth. I don't know the number of hours we sort of spend on this, and sort of like can we sort of rehash this...

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

A

Sure.

Q

...conversation on why are generics not a threat and is there anything that's going to change and this is going to go on to the – I always get people throwing out the – he's like well, there's legislation to open up the markets to make it more competitive and sort of price controls. And so talk about that whole gemish?

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

A

Yeah. So there are a number of factors that make animal health very different than human health in terms of generic penetration and competition. So A, it's the size of opportunity. So when we talk about a blockbuster in animal health, it's products that are greater than $100 million versus billions of dollars, and that $100 million is generated in 100 markets across the globe. So the opportunity there just from a revenue perspective is lower. Second component is margins are also lower in animal health than human health, again diminishing the potential opportunity. In addition, there's no impact of third party payers, right? This is direct payment, so that also limits the opportunities for generic and animal health. And in addition, Zoetis in particular, we're very focused – half of our R&D spend, when you break it down between the piece that isn't going to regulatory, is focused on lifecycle innovations and enhancements. So that continues to allow us to drive growth in products even after they've lost patent expiration.

So I'm not saying that we don't see any generic impact for some of our larger products. We would expect generics to be out there in terms of competition. And what we typically see is we typically see about a 20% to 40% impact to revenue once a generic hits the market, but that occurs over time. That doesn't occur a week or a month like you would see in human health. That occurs over many years where you'll see about a 20% to 40% impact to our revenue.

Q

Right, because RIMADYL still has – I mean, you're still getting like 80% of revenues or 70% of revenues from when it was branded?

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

A

Yeah, RIMADYL still has a very good portion of it.

Q

Sorry. Actually before I go on this next question, any questions from the audience?

Q

I have a question, really two. In the diagnostic end, two questions. Would that mostly be your direct sales force or you use distributors, and you feel the best way to do it is organically or would you do M&A?

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

A

So from a diagnostics perspective, A, we believe we can leverage our existing field force for lead generation. That being said, we do believe we need additional technical support to make sure that we'd be fully supporting our clients from a technical perspective as well. In terms of organic versus via M&A, so we do believe with what we acquired in the Scandinavian Micro Biodevices acquisition that we have acquired the appropriate R&D pipeline to grow that business internally with the assets that we currently have. M&A, we'll always evaluate M&A opportunities to the extent that it has the right strategic rationale, and equally important the right financial rationale. That's something we'll always consider.

Q

And the other question I have is pet insurance. Do you think that that will be taking off more and will that have an impact on reimbursements and payments?

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

A

Yeah. So what we've seen in pet insurance is it's really more focused on procedures and more catastrophic illnesses. We haven't really seen much pet insurance related to pharmaceuticals. And again, that goes a lot to the dynamics of what our price points are versus human health price points, lack of third party payers, et cetera. What we have seen is in some of the larger clinics they may have health wellness programs, and those larger clinics then may be able to exert some pricing influence in negotiations. But what we've seen is in those cases they also have better compliance and adherence, which leads to greater volume. So we don't really see a big impact of pet insurance moving forward.

Q

Yeah, there's one in the back. Great.

Q

Glenn, I recognize that a lot of the increase in livestock medicalization was a function of the weather. I'm just wondering if, historically, you've seen any of that additional medicalization be sticky through subsequent years even when weather patterns, livestock weights kind of regress to the mean.

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

A

So I think in terms of livestock business and how much the weather impact, I think we've seen that be pretty consistent. I think one of the things also the profitability that you see with your producers also has an impact. So to the extent that they're very profitable and they may then be willing to take less risk with the animals because of the probability, that also has an impact that may offset to some degree the weight of the animals as they come in and their susceptibility to illness.

Q

I think there's one over here.

Q

Hi. I was wondering in terms of M&A, would you guys ever be interested in owning a lab, like not in-vet lab but a lab outlet?

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

A

Yeah. So our current focus from a diagnostics perspective is more at the point of care and the in-clinic type units. So that being said, I wouldn't rule that out that it would be something that we will never ever be interested in. It would just be a continuum as we expand. Yeah, go ahead.

Q

No, I was going to say along those lines, you touched on the OTC angle although it's not a big presence for you. There's a question about reference labs. So where do you see Zoetis as the broader animal health [ph] peer (00:38:55)? I think [indiscernible] (00:38:56) on the last call talked about getting more into genetics. You're clearly making a push to the diagnostics. So is there an opportunity? If you're cherry-picking an OTC, how broad of an animal health company could you see yourself becoming?

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

A

So we are dedicated to the veterinarian, and that is our key area of focus. The other areas that we're interested in, as you mentioned, genetics is an area of interest for us; devices as well. We already are fairly large in bio devices for poultry, but we look to expand in devices as well. So those are some of the areas outside of our core business that we're interested in.

Q

So lot of interesting stuff going on in the animal health space recently. Obviously, the one is the spinout was successful from Pfizer. There's clearly some noise about some other big pharma companies potentially spinning out their businesses. I guess can you talk about the competitive dynamics because there's obviously you've got Elanco maybe deciding to do something; you had BI acquiring Merial a while ago; I mean, who knows what

Bayer's going to do in terms of their businesses. Sort of like how do you see the broader landscape sort of shaking out? And I guess what are some of the challenges that Zoetis faced going on their own that may not be appreciated by the Street or underappreciated?

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

A

Yeah, so it's a good question. In terms of the overall competitive landscape and if another competitor was to go stand-alone on IPO, A, we don't see that necessarily changing the dynamics of the marketplace significantly, right? We currently compete with pretty well-capitalized companies with significant size and scale. I think some of the things that are underappreciated of Zoetis going stand-alone, there are a lot of complexities in doing that and I think we did a tremendous job of making sure that we remain focused on delivering revenue and making sure that our commercial colleagues and our R&D colleagues as well as the manufacturing colleagues were isolated from the distraction that could be created from the IPO, and there was a lot of distraction. There's also a lot of complexity in making sure that you're able to operate as a standalone company to establish your systems, establish your processes. That takes a lot of time and effort.

So I think the fact that we were able to do that while still outpacing the market in terms of revenue growth was a tremendous accomplishment and it was complicated. So I think that's something that if somebody else was to try to do it, they would be faced with that potential distraction as well. So I think that was somewhat underappreciated in terms of what we were able to accomplish when doing the IPO.

Q

I mean, along those lines, speaking about Elanco and Bayer, one of the key questions we get that sort of there's no one right answer to is the valuation angle. We constantly get people comparing you to Pfizer and to Eli Lilly and the multiples they trade at, and it takes longer to explain what isn't similar versus what is similar in terms of R&D risk, generic risk, et cetera. And then there's generic companies, spec pharma companies, animal health diagnostics. So without a true comp set, how would you steal new investors? How do you think about your business and the metrics and the qualities that matter in terms of developing a comp sheet and looking at valuation and where you're trading?

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

A

So when we look at our overall business and some of the things that we think may be sort of underappreciated compared to like you say human health companies, and we really think, A, it's the predictability of our revenue but also the durability of our revenue streams. I mean, I think if you look at the animal health marketplace over the last number of years, you've seen that consistent growth in revenue in that mid-single-digit range. And when you look at the underlying factors moving forward, there's no reason that shouldn't continue in terms of increasing medicalization rates with pets, in terms of pets becoming part of the family, in terms of people being willing to spend more on the care of the pets from the companion animal perspective. Then from a livestock perspective, increasing population, increasing use of proteins, those are all strong core underlying drivers of growth moving forward.

Then when you add in to the fact what we talked about from a generic perspective, we don't lose large parts of our revenue streams very quickly, right? So if you're doing a DCF model or something of that nature and you're looking at the terminal growth rate, we believe our terminal growth rate should be very different than if you apply it to a human health company that does face generic competition. That can lose a significant amount of revenue the next day. So we think all of those factors really lead to really strong, predictable growth not only in the short-term but over much longer periods of time than you would see with other companies.

Q

And certainly, I mean, from my conversations with investors, I would say I've had more calls lately from consumer analysts and healthcare analysts. I think people are sort of looking at that business and realize that they're paying 23, 24 times for sugar water where these businesses they're not defensible, and so Zoetis is certainly very attractive in terms of looking at it from that perspective. And you mentioned the genetics angle. I think we certainly looked at that from the fact that some of our companies sell things with livestock breeding and sort of like optimizing the genetics of that. It's like – so can you talk a little about where you sort of see your interest in that through genetics/genomics of the animal health market? And like where can Zoetis sort of make a play or make a – what sort of advantages can you help the breeders to sort of go in with...?

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

A

Sure, absolutely. So there are a number of areas. So we're currently in the genetics space in terms of having products out there that can identify specific traits that we believe are favorable to our producers, and we think we could expand into other areas as well. So when you look at our overall continuum that we see for Zoetis in terms of prevention, prediction, detection, and treatment, really the prediction part comes with the genetics and that's really where our focus is currently. But we believe genetics will continue to be important to our producers and we want to make sure that we're providing them a full suite of services to help them effectively manage their business.

Q

Great. Any other questions from the audience? So I'll finish up with my – you've already sort of answered this, but I'll finish it anyway. But the biggest misconception about Zoetis?

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

A

Biggest misconception? That's a good question. I'll sort of answer it in terms of what we've said in the past in terms of the benefits that Zoetis has in competing in a very strong, stable industry with tremendous long-term growth, being the number one player in that industry, being diversified across all aspects of that industry from a species perspective as well as a therapeutic area perspective I think just speaks to the benefits that we have in a very strong marketplace.

Q

And it just sort of sparked my memory. Zoetis wasn't public during the most recent Great Recession, and so one of the questions we get in animal health has been the consumer sensitivity. Can you remind us what happened to the business during the financial downturn and like how sensitive is the business to sort of like the ups and downs of the consumer?

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

A

Yeah. So I think during the recession that we had back in 2008-2009, I think our growth was pretty flat to the low-single digits. So even in the worst of times in the near history, we were still able to pretty much maintain our revenue and I think even grow at some extent on an operational basis. So very resilient to challenging economic times.

Unverified Participant

[ph] Mike (00:46:48), anything?

Unverified Participant

I think we're – yeah.

Unverified Participant

And with that, we're right on time. And with that, thank you.

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

Great. Thank you.