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CORPORATE PARTICIPANTS

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

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

MANAGEMENT DISCUSSION SECTION

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

All right. Good afternoon, everyone. I think we'll get started with our next session which is Zoetis. Thanks very much. I'm John Kreger, the Animal Health Analyst that covers Zoetis here at William Blair. I'm required to tell you that you can obtain a full list of research disclosures and potential conflicts at williamblair.com. Thanks.

We are very pleased to have the company back. As I'm sure you all know Zoetis is the largest producer of products to the animal health industry. It's been very fun to watch the company progress since its spin out of Pfizer and they've got a lot of interesting things to fill you in on.

Logistically, we're going to do it a little bit differently. This is the last meeting in this room, so we'll go through a presentation over the next 25 or so minutes and then we'll go right into Q&A breakout out here in this room rather than proceed downstairs as we've been doing during the day.

Now, presenting for the company will be Juan Ramón Alaix, the CEO and then Cathy Knupp, the Head of R&D is also here and she'll take part in the Q&A.

So with that, I will turn it over to Juan Ramón.

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

Thank you, John. And I always appreciate the opportunity to participate in the William Blair Conference and to discuss about the unique characteristics of our industry, the animal health industry and also Zoetis. Before I start, I would like to make the comment of our presentation; will include forward-looking statements and a number of non-GAAP measures. You can read more about the risks and uncertainties that may affect our future results and find the reconciliation of our non-GAAP measures in our SEC filings.

Also, it's important to know that based on the recent announcement of the acquisition of Abaxis, also you can find more information in their filings with SEC and also in the website of Abaxis.

Today, I would like to cover three topics. So I will provide a brief summary of our results in the first quarter, then I will describe the trends and also the drivers of animal health and what makes animal health as an attractive investment. And then, finally I will talk about how are we investing to generate future growth and also, I will include as part of this, the investment discussion about Abaxis.

In the first quarter, we continue to generate profitable revenue growth. Thanks to the quality and diversity of our portfolio, also the innovation that we bring to the market and the value that we deliver to our customers.

We achieve 7% operational growth, driven by the performance of our dermatology portfolio and also the introduction of new products, including vaccines. We generated a growth in the U.S. and also in international markets. And this growth was sustained by our field force that has been maximizing the revenues on our new product launches, but also defending our existing portfolio.

We also generated a significant growth in terms of adjusted net income, 34% operational growth and this growth has been the result of revenue growth, but also improving in our cost that also drive improvement in gross margin. And finally, the positive impact of the recent change in the tax in the U.S. So the tax reform also had a very positive impact in our results.

In terms of species, companion animal grew by 11% operational and – again, so this was the result of the success of our dermatology portfolio, Apoquel, Cytopoint as well as also some of the products that we introduced in companion animal, including Simparica, the oral parasiticides. In the livestock, 6% growth and we have been growing in poultry, significant growth in that segment; also in cattle, swine and fish. What we see in the market, its similar market conditions in livestock and the one we communicated at the beginning of the year with the exception of dairy that we're expecting recovery on dairy in the second half of the year. We will take longer and we will see a recovery on dairy in 2019. In spite of that, we are convinced that we will be generating growth in livestock and this growth will be in line or faster than the market.

Moving into our industry, with no third-party payers, limited generic competition and also an efficient and productive R&D. As I said, the animal health industry offers a reliable and sustainable investment opportunity. It's an industry that generates \$150 billion with products and services meeting the needs of veterinarians, farmers, ranchers and pet owners. It's a market that virtually touches everyone in this room. Those who has a pet, a dog, a cat, but also people including their diet, animal proteins, milk, eggs or any type of meat.

We, Zoetis, compete mainly in what we define the core of animal health, the one which is showing [ph] this fiscal (00:07:00) with \$32 billion which includes vaccines, pharmaceutical, parasiticides, medicated feed additives. I have been working in the animal health industry since 2006 and now I have understanding of trends, dynamics that are driving growth and steady growth in this segment.

In the last five years, animal health added \$6 billion in revenue from \$26 billion back in 2013 to the \$32 billion that reported at the end of 2017 and we are expecting that in the next five years, this industry will be reaching \$41 billion, so very consistent growth. And one of the things that also define animal health, it's the resilience against economic crisis, against regulatory changes and even consumer preference, because the diversity of our portfolio, the animal health portfolio in terms of geographies, species and therapeutic areas is really creating a very resilient model.

Let me now maybe describe what is making this industry so predictable and it's related to trends that are very consistent and trends that are really not changing over time. So we'll see increased number of animals both in companion animal and livestock. More animal health to meet the needs of the population in terms of animal proteins, but also the animals that will be increasing in terms of adoption in companion animal.

We also expect that it will be higher medicalization rates and we see that in some of the markets like the U.S. medicalization freights in companion animal, it's about 70% compared to international markets, about 40%, so a

significant opportunity to increase medicalization rates. And also, more people and also increasing the traffic driving additional consumption of animal proteins and these animal proteins will need to be produced in a way that will be efficient, producing enough quantity, but also affordable food.

And this will be facing the challenge of limited resources and in some cases also challenging technologies that today are helping producers to achieve the productivity. Companies like Zoetis, we can have the opportunity to bring this type of solutions to our customers to meet the challenge of producing more with less.

We have been in this industry since 1952 as a public company since [ph] 2013 (00:10:31), but we have now many years of experience in animal health and through many internal growth and also acquisitions, we are leading the animal health industry and we are leading in many different dimensions, geographies, species, therapeutic areas.

Now, as an independent company, we also have a singular focus, which is also driving more value to our customers and also helping us really to support our revenues. We have a significant diverse portfolio and also a very durable portfolio. We have 300 product lines that are commercialized in 100 markets. But the durability of our portfolio it's as shown with the data that we reported at the end of 2017. The top 24 products in our portfolio has been in the market for an average of 30 years. You see that this is probably the confirmation that generic competition in our industry. They have very different impact that – in human health.

Some of the new products that we introduced are now part [indiscernible] (00:12:02) products like Apoquel, Cytopoint, Simparica. They are now big sellers, top sellers in our portfolio and generating a significant growth. But there are many other products that are significant for Zoetis and will remain significant in the future.

One of the reasons why we maintain our leadership in animal health is because we have excellent portfolio. We have the team supporting this portfolio, but also we have a business model that has been developed since many years and it's including the combination and the interaction of the [ph] three (00:12:48) interconnected capabilities, our direct access to customers. I mentioned that we are in 100 markets, but in 45 of these markets with our direct field force, our presence in the market.

And these 45 markets represent total revenues for Zoetis and also the potential of the market of 95%. So these 45 are important part of the focus for Zoetis and also significant generation of revenues and profits. It's also based on the innovation [ph] that we'll bring to (00:13:24) the market with many examples of products that have been changing the way that veterinarians, farmers, pet owners are taking care of the animals. So we have an R&D that has been showing excellent results in terms of productivity. We have about 1,000 scientists located, most of them in Kalamazoo, but also collocated in manufacturing implants around the world.

This manufacturing plant is also the third characteristic that it's also very important for Zoetis, a very important to bring value to our customers, which is the quality of our manufacturing. And these are quality of manufacturing. It's in about 20-plus plants which are including vaccines. They're including also pharmaceuticals. This is definitely the combination of the three are creating a competitive advantage.

Now, let me describe how we are investing to support our short and long-term profitable revenue growth. The first is investing in commercial, investing in new products to maximize the opportunities that these products are generating, but ensuring that we have the right support to our inline portfolio. We are also expanding our field force into diagnostics. This was even before the acquisition of Abaxis. We plan for 2018 to develop our internal resources to support the future portfolio of diagnostics.

In terms of other activities that we are doing in 2018, it's ensuring that our Apoquel, Simparica and all the products they get enough promotional support, including the – also direct-to-consumer advertising. In terms of R&D, we continue ensuring that we'd identify the needs of our customers. And again, these interconnected capabilities are helping us to understand these needs, because we have very close interaction with commercial and R&D to understand these needs. And one of the [indiscernible] (00:16:02) that definitely are part of our investment is, continue developing the monoclonal antibodies.

We had a significant success with interaction of Cytospor. Cytospor, a monoclonal antibody for allergic dermatitis, but we see now with the acquisition of Nexvet. And also, the recent announcement, the collaboration with Regeneron that will reinforce our programs in monoclonal antibodies targeting pain, also renal and oncology and many other indications. We will continue investing in expanding our portfolio in parasiticides, now we have an oral parasiticide, Simparica. We already introduced the first combination of our product, Simparica together with selamectin which is the active ingredient of Revolution, targeting in that case, cats with a topical formulation. And the next-generation of parasiticides will be a combination of sarolaner with another two different agents that will be covering internal and external parasiticides.

And as part of our efforts, so we'll continue ensuring that we invest in vaccines to ensure that we protect and we prevent diseases in animals both in companion animal and livestock. Additionally, R&D, we have identified the opportunity of investing in China. In China, we have already one laboratory that is mainly focused on swine and cattle. We have our second laboratory as part of the investment that we're making also to expanding our footprint in terms of manufacturing also for R&D. And this will be also including the fish as part of the product that we plan to develop.

We also invest in diagnostics, not only because of Abaxis, but also the acquisition that we made in 2016 with acquisition of Scandinavian Micro Devices (sic) [Scandinavian Micro Biodevices] also it's a portfolio that we're developing in diagnostics. In terms of manufacturing, I mentioned China, in China we start the construction of a new vaccine plant that we expect will be operational in a couple of years. And this vaccine will be mainly focused on producing vaccines for China maybe with a potential of some export opportunities in the region.

We also acquired our active pharmaceutical ingredient plant in Ireland. It's in a place called Rathdrum. And the objective here is to be less dependent on third parties on the production of key active ingredients including Apoquel, including Simparica, DRAXXIN and some of the products that we want to ensure that we have access to the production and less dependent on third-party suppliers.

And finally, we're also expanding capacity and capabilities in Michigan in Kalamazoo, [indiscernible] (00:19:28) oral formulations and in Charles City, Iowa also to produce vaccines for poultry, including also vector technology.

And on top of this internal investment which has been always our priority in terms of capital allocation. We're also identifying external opportunities and the external opportunities that you have seen recently has been Abaxis, but in the past has been also PHARMAQ to enter into fish vaccines or the Scandinavian Micro Biodevices [ph] Abbott (00:20:15), some acquisitions that we made since becoming independent and public company.

What we think will be important for the future is moving into a model that will be much more integrated. We think that offering to our customers are more comprehensive portfolio, will create significant value for us and also will create a position for Zoetis that will become much more relevant today. We'll continue investing in R&D in our core business and we're allocating 7% to 8% of our revenues to R&D.

But we want to make sure also that we are not just focused on vaccines or pharmaceuticals, but we offer to our customers what we describe as a continuum of care starting from prediction with genetic markers. And we are already offering genetic markers, especially in the dairy industry, but also preventing with large portfolio of vaccines. Also, detecting, detecting will be through diagnostics, but also through sensors or devices that will help to identify behavior in animals, how these animals are feeding or drinking or moving and this will also create information that will be valid in terms of productivity for these animals.

And finally, we want to make sure that we also have strong portfolio of treating animals, when these animals despite of their prediction, prevention and everything, they get sick and we have today significant portfolio in this category that also will be supported in the future.

Together with all these elements, we are convinced that the way to increase productivity in livestock and to improve the quality of the healthcare in companion animal will be through data and the objective is getting data from genetics, from [indiscernible] (00:22:39) from diagnostics and really translate these data into information that will be incorporated in the decisions of our customers. All that will create against a competitive advantage that will make Zoetis definitely ahead of the rest of our competitors.

On top of that, we're also a company which is delivering very strong results. You see in this slide that we have been very consistent in terms of growing faster in the market since we became public. This is our operational revenue. And in every single year, despite [indiscernible] (00:23:31) of the separation, despite of our operational efficiency program, despite of many things, we have been very consistent, growing faster than the market.

And this is something that should be also seen together with the ability that Zoetis in terms of generating higher margins over time and we significantly increase our margins in the last three years. We increased our margins by 910 basis points of profitability.

So we are definitely a company that is delivering based on growth despite that we are already a market leaders in the animal health industry. And one of the things that I also want to share with you is that we want to continue identifying opportunities to make this company stronger and even more successful in the future.

The acquisition of Abaxis, it's helping us to enter into a market that – it's a market of \$3 billion, so market that, mainly it's generating \$3 billion in companion animal. And it has been growing faster than the animal health industry, the animal health industry growing 5% to 6%. In the last three years, diagnostics have been growing about 10%.

We identify Abaxis as the rightest fit for Zoetis. It's a second largest animal diagnostic company in animal health. The acquisition costs \$2 billion, but we are convinced that we can generate significant value to justify much more than this \$2 billion. And then we now maybe describe what we think are the strategic rationale for this acquisition.

The first thing is that we see a significant opportunity in international markets. I mentioned at the beginning that in the U.S., medicalized pets in companion animal is 70% only 40% international markets but even in this medicalized pets international markets, the level of penetration of diagnostic equipment is much lower than in the U.S. We see also that in international markets, there is no any key player that can generate significant growth in this space. More so, the diagnostic companies they have little presence and also they are lacking critical mass to be successful.

With the combination of Abaxis and Zoetis, from day one, we have both the access to the customers, but also the portfolio that we'll be combining diagnostics and also our core business and [indiscernible] (00:26:45) significant critical mass that in our opinion will help us to penetrate and to develop the international markets for diagnostics.

And finally, also in the longer term, we have identified a significant unmet need in livestock. In livestock, the way that they use diagnostic is through reference labs. It's taking sample from animals, sending these samples [ph] block (00:27:15) to the laboratories and then wait one to three days to get the information back to the farmer.

We are convinced that developing a portfolio of equipment at the point of care will help our farmers to have faster decisions in terms of diseases and also faster decision in terms of the protocols that they will be implementing to keep the animals productive. So, definitely a significant opportunity for Zoetis entering into diagnostics and complementing our portfolio with these new portfolio and becoming even more relevant than today offering our customers a broader set of products and services.

When we became public in 2013, we communicated our valuable position to our investors. And what we communicated to them is still valid today. We are targeting to grow revenues in line or faster than the market. We have been growing there much faster than the market in the first five years. Also, we want to ensure that our adjusted net incomes are growing faster than revenues. It is something that we are also delivering.

We are targeting value-added investment opportunities both internal and external to create future value for this company as to sustain our revenue growth and to return excess capital to our shareholders. And we're also doing that through dividends and also buying shares back.

Finally, let me say that we are the leaders in an attractive industry and attractive that it's growing and it's growing steady in a predictable way. We have the characteristics and also the business model to be successful and also we are evolving into a much more comprehensive [indiscernible] (00:29:28) solutions. And we are consistently delivering profitable revenue growth. And we also targeting and delivering a significant cash that will also help us to sustain the investment that will maintain our short- and long-term objectives.

Thank you very much for your attention. And now, it'll be opened up for questions.

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