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Zoetis, Inc. (ZTS)

Stifel Dental and Veterinary Conference

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MANAGEMENT DISCUSSION SECTION

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

Hi guys, we're going to go ahead and get started and try to stay on time and sort of entering late afternoon. And we have with us here Zoetis, who was kind enough to come. We've got Glenn David, CFO; Kristin Peck, Executive Vice President and President of U.S. Operations; and Steve Frank, Vice President of IR.

Kristin, I thought maybe a good place to start is, we were ambitious enough or silly enough about seven months ago to start this livestock monthly report. We try to put together a bunch of information from USDA, look at it and trend it over time.

And if I look at the results in sort of March, April, May versus when we started in October or November of last year, it looks like the U.S. livestock market is strengthening. I mean, you're seeing certain metrics of feedlot placements up year-over-year, accelerating. Yet when I tie it back to the numbers, the U.S. livestock numbers from – that I see from you guys I'm yet to see a play out in the P&L.

QUESTION AND ANSWER SECTION

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

And so, maybe if you can just walk us through, maybe a broad overview of the U.S. livestock market? I want to go maybe a target approach in U.S. beef. And so, those placements that we've seen from the USDA that maybe hasn't translated into the P&L, maybe the disconnect, or if you can comment on that.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.
A

Sure. I think your broad trends in the beef industry are correct. It has been improving. And I would say, profitability across the value chain, as those who cover beef know, most cows in the U.S. and steers are born in cow-calf operations. They then often go to a stocker/backgrounder and then to a feedlot, they can skip the middle step. But what I would say who's making money in beef? The question is, is everyone making money in beef or is it only one or two? Or is it just the packer?

I would say for the first time in a while, most of those players are making money. For the feedlots, it's important what value they buy the animals in it, and what they can sell them at because they keep them for a while. So, their forward projection of what the market is going to look like defines how much they're willing to pay for the animal.

So, I think we're at a place now where the price has gotten both on live cattle, which are cattle being sold into packers, as well as in feeder cattle and most are profitable. But that's been also partly because the weather has been great. And so, the cow-calf and stocker/backgrounder have kept those animals much longer. And they're going into feedlots heavier and older, which is good for a feedlot guy, not necessarily for Zoetis.

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

From a pharmaceutical perspective.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.
A

So, if you make products that help sick animals, if animals are getting less sick, you make less money. So, I would say it's good for the industry and healthy economics for our customers, is in a medium to long term good for us. The short term of great weather and everyone being profitable and keeping those animals longer has met fewer sales of those type of products for us. So, I think cattle beef for us was flat for the Q1. That was growth in a number of key products like ACTOGAIN and SYNOVEX and strong performance in dairy, but obviously a decline in some of our anti-infectives.

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

So, you've got to look at those placements. You've got to adjust it by the weight. You've got to take weather into account. But by and large, did you feel like the overall environment is improving and we've seen sort of the live cattle, the pricing start to pick up...

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Yes.

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

Q

...and corn remains somewhat modest. So, in terms of that profitability to the producer that's looking better today than where we were six months ago.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Yeah. And I think it's also important to look at few things from the producer perspective the spread between feeder and live cattle prices. The question is whether they have money; it's not just what they sell it up and what they bought it up. And I think that spread is looking good. I think that's the other reason.

I think you'll probably see – I mean, most people are predicting live cattle prices to go down a little bit and then recover toward the end of the year. It's a little bit cyclical. But I think the trends are good. I think the risk – the real question is people are asking is what's the forward supply of cattle, so, are they going to expand the herd.

And if you look at cattle [ph] facts in universe (3:40), I mean, most people are looking 0% to 1% expansion overall in the herd. And the question is will it be closer to 1% or closer to 0%, will that be accurate? And I think that's really expectations for forward-looking markets. And I think the big risk in the U.S. that I think most people are concerned about is not domestic consumption, but the export market and trade.

As everyone read in the paper every day, there's a lot of talk right now around blowing up NAFTA. Well, Mexico is one of U.S.'s biggest trading partners in beef. We export a tremendous amount of beef to Mexico. So there's a lot of anxiety, I would say, as to whether it's a willingness to expand the herd and beef is what's going on with a lot of these bilateral agreements. And do we want to be expanding supply if we're not really sure where export demand is going to go. So, I think that's the anxiety and the uncertainty...

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

Q

Okay.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

...in the beef industry. But I'm not expecting a huge recovery, but I don't think things are going to get worse unless we see some type of exporter trade shock with some of these agreements [indiscernible] (4:33).

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

Q

And so, maybe just to sort of tie-up on the beef side of thing. People are hyper focused on the live cattle, but to your point [indiscernible] (4:39) this thing called the cattle crush, which was pretty enlightening the first time I had heard of, but looking at live cattle and feeder and corn and doing the lag, and when they're buying and then beefing up the animal. That seems to be in a better place today versus where we were.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.
A

And I think most people – the economics for most people across the value chain are good. They're not great, but they're good. Everyone – no one is losing money at this point. As you know, last year, for a lot of the year, the feeder or the feedlots were losing money. And cow-calf guys are making a ton. Because remember, they sold those feeder cattle at very high prices. They could keep them on grass for a long time, they were doing well.

Now, the economics have shifted and the spreads between feeder and live are better. So, I think everyone's making money, they're not losing money. I think, unless there's a big shock, I will see that continue. Do I think it's going to improve dramatically? Not unless the export market starts picking up some of the supply.

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

Okay. And then, just I want to ask one on U.S. dairy as well, and then Glenn, turn to you on a couple of P&L-specific items. But on U.S dairy, there were some pretty cautious articles recently [indiscernible] (5:32) just talking about oversupply. And so, while you just touched on beef, maybe if you can talk to U.S. dairy and what's going on there and how you see that unfolding.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.
A

And to give you a sense of size, so if you look at the U.S. market and you look at cattle when we report cattle, it's about 50% beef, 40% dairy. So dairy is not as big as beef, but it's pretty consequential for us overall. And it's been – dairy is generally very cyclical. The supply/demand is generally relatively, they often for whatever reason, tend to have more extremes. Right now, most dairymen in most of the country are making money. That being said, they are dumping a lot of milk.

So, the price is good, but they have an oversupply. They have to make decisions, you think about it, a year plus before, how many cows they're going to breed or how many heifers they're going to breed, and so, sometimes you end up with supply more than what you want. It's cheaper often with some of those animals to just throw out some of that milk.

The U.S. is also currently sitting on a surplus of both butter and cheese. The question is will that work its way out? The producers are still making money for the most part right now. So, there isn't oversupply, but their economics are such with where prices are, that they're not losing money. Again, that's going to be a big question in exports, which is much more immediate.

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

It could soak up some of that oversupply or...

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.
A

It could or could make it worse.

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

Okay.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

And where that is, everyone have been reading the whole Canada-dairy, Trump's Canada argument over dairy, that's pretty important to the U.S. dairymen. So, if some of these export markets again to U.S. – for the U.S. or Mexico and Canada become a trouble, I think the dairy could go negative if that export market starts to decline.

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

Q

And just so I conceptualize this. I mean, if you're faced with oversupply, you either hope that demand [ph] picks up (7:11), you've got greater exports or if that's not going to transpire, you call your herd.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Correct.

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

Q

And that's where the negative impact comes in for you guys.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Yes. Absolutely.

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

Q

Okay. Okay. And, Glenn, just I'm going to just bounce around a little bit livestock specific in the P&L. You guys certainly outperformed in the quarter. Maybe we were out there, [indiscernible] (7:30) you talked about 0% adjusted net income growth I think in the first half of the year and I believe the number came in at 10%.

So, can you just walk us through what played out better in 1Q than you had anticipated? Again, I know you don't guide specifically on a quarterly basis, but clearly there were some upside leverage in the quarter.

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

A

Yes. So, for the first half of the year, we did discuss limited income growth in the first half of the year, and there are a couple of drivers to that. A, the impact of the SKU rationalization was negatively impacting the first half of the year more than the second half of the year.

However, some of the things that drove that 10%, which was beyond sort of what we expected, when you look at the revenue line, we delivered 6% revenue growth even with the negative impact of the SKU rationalization.

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

Q

Which was about 2%?

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

A

Which was about 2%. And we also had negative impact from calendar days as well, which was about another 1%. So, when you normalize for that, we had a strong growth of almost 9%. Some of the factors that were better than we thought so when you look at some of the emerging markets. So, China performed very well at 47%, and we weren't expecting that level of growth, as well as Brazil with 15%.

The other factor that was positive was around the Simparica launch and the success that we had in Q1. So, we had about $29 million in sales in Simparica. Now, we did also discuss that we expect that number to go down in Q2 just based on the timing of the buying pattern of U.S. veterinarians. So, that was another positive factor.

But when we were looking at the revenue for the full year and for the first half, the revenue growth for the full year, 5.5% to 7.5%, with the negative 2% impact from the SKU rationalization in the first half, we were looking at 3.5% to 5.5% at the revenue line. So, we came a little above that at 6%, but we always knew some of the challenges that we saw with COGS, we're going to come – we guided to that. So, that negatively impacted the net income growth.

So, really the strong growth in revenue with some of the surprises, as well as some of the timing of the operating expenses between Q1 and Q2. It fell a little more favorably with some of the expenses shifting into Q2.

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

Q

Okay. And then on that rationalization of 2%, I mean, to your point, it's going to all be 1H 2017-oriented.

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

A

Yeah.

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

Q

Does the 2%, another 2% in 2Q or it is 2% go to 1%? I'm guessing 0% in the back part of the year?

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

A

Yeah. Similar in Q2, and then essentially 0% in the back part of the year.

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

Q

Okay. Okay. Got you. Got you. And then maybe just to go back – I mean, I'm going to go back and forth between livestock business and some P&L-specific. U.S. swine, I mean, we hear about how that strong that market is. Maybe if you can comment, Kristin, what you're seeing there. Huge export numbers, I believe...

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Exactly.

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

Q

And maybe just the over or underweighting that Zoetis has to that particular market?

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Sure. We'd very much agree the U.S. swine market is doing really well. The U.S. swine market is primarily being driven by China exports at this point. Obviously, Smithfield was bought by a Chinese company and a number of packing plants has been dedicated to China production. For those who don't know, they actually have different requirements in China for what needs to be exported, and that really [ph] blends itself to (10:26) having a dedicated plant to exactly processing specific animals for China.

I don't see any reason that market will not continue to grow. I think that's a pretty secure growth. We have not been growing the same way. We had a rough end of 2016 and a rough beginning of 2017. That has to do with one of the largest biological products in swine, PCV2, porcine circovirus. We had a challenge with one of our products, and one of our competitors was doing better in head-to-head trials with some of our – our product was not doing as well as the competitor product.

We've reworked the product. We ran some large-scale trials at the end of last year. And at the beginning of this year, we had great results on that. We are now in Q2 in the market with the enhanced vaccine with our producers...

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

Q

So, you're literally – you're out there selling that.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

As of – yes, as of Q2.

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

Q

As of Q2.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

It was not in Q1, but as of Q2.

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

Q

Okay. And you've got your head-to-head trial data, which goes ahead and sort of, [ph] I don't say refutes (11:18), but sort of battles back against what that competitor had shown in prior quarters.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Absolutely. But I say this, it's going to take a while to [ph] rear in (11:24) that whole market to manage expectations. The reason is in different production systems, they see differently, they have different protocols. So, we've done in a few production systems where we can get those sales, but we're going to have to run trials. They're not going to convert, given the challenges they had before, until we can prove in their system that our product reacts the same way. This is very common in livestock, where people want to see how your product performs with their protocol.

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

Q

Okay.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

So, I think we'll earn it back. And we're also very focused, as I think Glenn and others have spoken about, in innovating in combo products in the space. I think we've got to continue to do what we have done previously with PCV2 M Hyo. It's continued to add combination products and to continue to enhance our portfolio that way, which we'll obviously continue to focus on doing. You've seen us do in our markets around the world.

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

Q

And so, that PCV2 headwind – I mean, I'm [ph] sure sometimes there's going to be (12:12) headwinds and tailwinds, that sort of did negatively impact you guys, what, the back half of 2016? And then...

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

[indiscernible] (12:22) last three quarters, I mean...

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

Q

The last three quarters of 2016?

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Yeah.

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

Q

And arguably, to your point, it's now out there. You're selling. And over time...

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

We're selling, but it's going to take – we got to earn – we're going to have to earn back that business. And we're really focused on doing that customer-by-customer in the U.S. We're confident we can, but I want to manage our expectations that pigs live for six months, you're going to have to get a full flow in with some of these other bigger customers and demonstrate with that full flow they had the same experience. So, my expectation is we can earn that back by 2018. We'll do better. You'll see improvement this year in swine and some growth. But really earning that full market back is going to take us into 2018.

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

Q

Okay. And, Glenn, got you. I'll pressure a little bit on gross margins. I've got a lot of questions on gross margins and the cadence throughout the year. And I think I give an okay answer, but certainly not a great one, so talk to us about it. 1Q came in as expected.

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

A

Yes.

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

Q

You expect an incremental improvement in 2Q. But to get to your full-year gross margin [ph] goal (13:12), you need a pretty big step-up in [ph] 3Q and 4Q (13:14) to get there. So, what are the nuances or moving parts that led to the suppressed 1H versus 2H? And when we start to think about 2018, is that the run rate that we're going off of the exit?

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

A

Right. So, I'll start with the good news and that, as part of our operational efficiency initiative and the work that we have been doing with our GMS group, our manufacturing group, we've been able to get significant cost improvements moving forward.

Now, as you look at that, you still need to work through inventory that was produced at prior year's cost. So, what we're facing in the first half of the year is working through that inventory. And because of the timing of which we do that, it is accelerated working through that inventory into the first half of the year. So, we have that impact in Q1 and Q2.

And then in the second half of the year, we're really working under the new cost structure and the new cost of goods, and you'll see that full benefit in Q3 and Q4, and that's how we get to the average for the year. And then that is a better base than to think of how we'll be in the future as well.

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

Q

Okay. So, then when we think about some of the manufacturing initiatives that you have and you talked about a 200 basis point lift, clearly it's very different math there, [ph] if it's a (14:20) 200 basis point lift on the full year 2017 or the 1Q 2017, so we think about that 200 basis point, it's off of what?

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

A

That's off of full year 2017.

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

Q

That's off of the full year 2017. And I don't want to get too far down the road of accounting because [indiscernible] (14:34). But I guess the only thing that I don't understand in terms of burning through that prior inventory is, correct me if I'm wrong, but your 4Q 2016 gross margins were strong. So, why, if you were working off the prior inventory was 4Q okay, and then you saw the [indiscernible] (14:47) in the 1Q, if that make sense?

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

A

Yeah. So, 4Q actually did have some negative components as well...

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

Q

Okay.

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

A

...particularly around supply that we needed to write-off. So 4Q, there were some negative impacts in gross margin as well. And as you get into the first half of the year, is when you start working through process-wise, you start on the new standards that you established, the new cost that you established for 2017. However, you still need to work through the inventory in the previous year. Now, it's not that you're actually working through the inventory. It's an accounting entry essentially...

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

Q

Okay.

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

A

...that you need to book. And the timing of which you do that, it's accelerated to within the first half of the year, it's not over the full inventory turn. So, that's really what creates the disparity in terms of it being heavier in the first half of the year, it's that the timing of which you recognize those costs are over a shorter period than your full inventory turn.

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

Q

Okay. And despite that big, what seems like, on paper, a big pick-up in 2H versus 1H, you guys are – seem very confident that...

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

A

Yeah. I mean, the key thing is, like we said, we saw this all along. It's a technical process that we knew was going to occur in Q1. We see it coming into Q2. It was not a surprise. It was always built into our full-year guidance and we reaffirmed our guidance as well in May for [indiscernible] (16:01).

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

Q

Okay, okay. And, Kristin, the Veterinary Feed Directive is something that is not front in center that we live with everyday, but I think it was implemented in Jan 1, 2017 and you guys called it out as a headwind, I believe, a 3% headwind to your...

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Correct.

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

Q

...U.S. livestock business. How did that dissipate over time? I guess, if you can walk me through how does Zoetis work better or hand-in-hand with your customers, where that was a prominent headwind in 1Q and then we see it sort of diminishing 2Q and beyond?

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Sure. So, the Veterinary Feed Directive, for those who don't know, was a voluntary effort by the industry to work with the FDA and CVM to put regulations in place that require that anyone who uses an antibiotic has a veterinary-patient relationship.

So, any farmer for [ph] her cow-calf has (16:45) to have a vet visit, so a veterinary-patient relationship. And they must have a prescription for a drug because of the existence or they need to control of an actual disease. So, that is to prevent anyone from using any products even there was an on-label to use them off label, use them for growth promotion, use them when they're not needed, which we think is always – Zoetis really believe the vet should be in the center of things.

The challenge is, to be honest with you, a lot of small cow-calf producers and even smaller producers overall didn't need a vet historically to be there all the time because they could buy a lot of those products and use those products without a prescription.

We knew this was coming and I think they did. They just kind of thought it wouldn't really matter as much or they figured it out. They now can't actually buy products from feed supply stores without a prescription.

And so, what's happening is they're having [ph] difficulty (17:32) to find a vet who will come out to their farm to visit their animals, diagnose the disease, that takes time. So, I think a lot of cow-calf producers were kind of caught off guard in a sense that they wouldn't be able to just go buy the product or they saw that last year. You actually have to have the presence of a disease or the risk of a disease because there's exposure at a farm next to you in order to get a prescription.

So, I think [ph] part of what they (17:53) have to do is they have to build these relationships with vets. But the other thing is everything has to be used exactly on label. That's the other part of the regulation that was passed and making sure that vets understand and producers understand exactly what the label is, exactly how to use it. If they don't know, they don't want to get in trouble because the FDA and the CDM is auditing, whether or not the VFD has been tracked.

So, it sounds very technical. But to get a prescription, you have to have the relationship. You have to have a prescription, the feed yard has to have that prescription so that they know it and have to be very specific of the number of animals and the weight of your animals. There's a lot of them out there, and nobody wants to get in trouble with the FDA or CDM. This is a new thing for vets, so they're a little nervous in getting the relationship.

So, we believe, over time, farmers will get a veterinary relationship and, over time, the vets will get comfortable with how to use this new system and be able to know exactly what's on label. So, there's some of it that used that was not being used correctly.

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

Q

Yes.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

I'd call that very small. That will go away. But, over time, we believe the veterinary relationship will be established and the vets will better understand how to prescribe [indiscernible] (18:53).

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

Q

And how quicker – how fast are they able to sort of change their behavior and make those adjustments, and, I guess, where I'm going with it is we had the month-to-month cadence. Did the headwind – was that headwind less in March of 2017 versus what you guys saw in January, which gives you some confidence that this will subside over time?

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

There's not a lot of great indicators of what that is. They don't track how many people have a veterinarian-patient relationship. So, the honest answer is it's hard for us to sort of have a sense. What we're spending a lot of our time from a customer experience is helping our customers make sure they have and helping connect them.

I mean, some of us, we knew this was coming for [ph] two (19:31) years. So, you would have thought [indiscernible] (19:33). So, I would say I would have expected better than what we're getting. So, I don't have a lot of indicators to say other than they don't want sick animals. They're ultimately going to have to figure this out. And therefore, I believe it will happen over time. I don't have a really good sense of January versus March honestly. I think it will improve over the course of the year.

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

Q

Over the course of 2017. Okay. And, Glenn, maybe just to shift to companion animal, you guys changed some of your contracts with the distributors this year and went away from exclusivity on some products, I think that's – people don't understand that, not all products but some products...

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

A

Right.

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

Q

...and went to more to sort of a volume-based contract. I think there was a lot consternation in the market in terms of what that meant on generic uptake. Maybe just [ph] start with (20:11) why did you guys make that change, which I believe you proactively made as a company, but why did you alter some of those contracts?

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

A

Well, I'll let Kristin answer that since she's run [indiscernible] (20:19).

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

Sure. We've continued to evolve our relationship with distributors over the last two or three years since I've been in my role as our portfolio has expanded. We see primary demand generation from our field force. We have the largest, in my view, have the best field force in the industry. But as our portfolio keeps expanding, we, obviously, can't continue the detail all of those products, plus many of our customers, from a convenience perspective, they [indiscernible] (20:46) work with distributors, et cetera.

So, we've always used distributors in different ways. About two years ago, as we were launching a lot of new products in the U.S. around Apoquel and a number of bios, we felt that it would be helpful to expand the portfolio we had with distribution. So, last year in Q1, if you – let me remember in our financials, we actually moved biologicals and companion animal into distribution for them to sell it because we had a lot of product launches and a lot of things to cover.

As we experienced last year and we looked into 2017, competing in the parasiticides market was a pretty big change for us. It's extremely competitive. We were not a big player, as many of you know, in that market. And we really felt like expanding reach in frequency, which is what we think distribution does really well for us, was really important. It also stops them, honestly, from cross-detailing if they carry everyone's product but ours. There was a common enemy which was us. So, it was also just to neutralize that.

And we also started looking at – distributors came to us and said, we really want to carry some of these generics. And our view was, since they weren't detailing a lot of these, our products in these spaces, CLAVAMOX, RIMADYL, anymore, our investment in technical wasn't that great. And the reality was most of our vets were carrying both. They were just buying it from a different distributor. So, we made the decision to say, look, if you commit to maintaining and growing volumes, we'll let you carry anyone's product including ours. And vets were selling these – everyone had access.

And I think what you've seen and I've heard at least from the one-on-ones I've already had today, it's been a win-win this year. I think you've seen in the U.S. our numbers, 10% growth in the U.S. in companion animal in Q1. We're doing well, and I think our distributors would say the same. And I've seen some of their Q1 reports and some of the comments. It's been a win-win, but it will continue to evolve as where we see they can be helpful and where we can find win-win relationships though.

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

Q

Okay. And maybe just to follow-up then on this generic component, I mean, I think we've taken the approach of saying, hey, generics are real and they matter, and there's going to be a little bit of a headwind and you guys have broken out the past two years, I believe, in your K. [ph] That RIMADYL (22:45) was down 5% or 6% [indiscernible] (22:47) down 5% or 6%, but we're going to spend most of our time figuring out if Apoquel is a $300 million or $400 million product or Cytopoint is $100 million to $200 million. Is that sort of where people are led astray when they think about the generic while they're so used to human and what happens over there, they're sort of missing all the different components that are a big part of the companion animal space.

Kristin C. Peck — A
Executive Vice President & President-US Operations, Zoetis, Inc.

Yeah. I mean, generic matter in companion animal, [indiscernible] (23:11) they do. But it's quite different than human health for a host of reasons: One is it's not as an attractive space for some of the large generic companies to get into. A blockbuster in animal health is $100 million, and that would be across many, many markets. So, in any individual market, it's not that big a product. But you can make money selling it, but you're not going to have the big price discounting for two reasons: One is there's not a third-party payer. There's no big incentive to move to generics. And, secondly, you therefore have to sell the generic They're going to have to invest in marketing that product, either getting distribution to sell it, which will cost you a lot more than getting AmerisourceBergen going to sell you a human healthcare product, et cetera.

So, what we see is, whether it's a new generic, we'll likely over time lose 20% to 30%. But as you see in our Ks, it's not immediate, it takes a few years for that to happen. So, it's definitely a factor. But what I would say people, it's baked into our numbers that everyone asked, do we see any different trends in Q1, which is exactly as we expected, which is they, of course, do affect our portfolio. But we have a good sense of what that looks like and it hasn't been any different than what we've seen historically. [indiscernible] (24:14).

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

No, I think you covered it.

Jonathan Block — Q
Analyst, Stifel, Nicolaus & Co., Inc.

Okay. Then Glenn, just [indiscernible] (24:18) on the cash flow perspective when sort of Zoetis spun off they had a lot of stuff on their plate...

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

Yes.

Jonathan Block — Q
Analyst, Stifel, Nicolaus & Co., Inc.

...in terms of taking up cash and that's dramatically changed. So, maybe if you can compare and contrast current dynamics around cash flow today versus what you saw 12 to 24 months ago? And then, from a deployment standpoint, where does that open up and allows you guys to go and...

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

Yeah. So, when you look at it from spinning out to going through the operational efficiency initiative, we had a fair amount of significant one-time costs that did put a drain on cash in the last number of years. Good news is we're outside of most of those costs now. So, as we go into 2017, we really see our operating cash flow approximating pretty close to our adjusted net income, which, if you look at our cash flow generation from 2016, it's a significant jump.

So, that does give us a lot more opportunity then to deploy that cash. And there are a number of areas that we continue to look at from a priority perspective. A, the first is always internal, are there any needs from an R&D perspective, from a manufacturing perspective, or from a commercial perspective to further support our existing portfolio or our future portfolio.

We'll then focus on business development areas that could complement our existing businesses or areas within our core or areas in developing markets or emerging markets, where we don't have quite the presence that we would like to have. Then, with what remains will remain excess cash to our – we return excess cash to our shareholders. We currently have a dividend around 0.7%. We'll continue to grow that pretty much in line or faster than our growth in adjusted net income. And then we have our return program in place. So, we're authorized for $1.5 billion in share repurchase that will occur over a number of years. We view that as very flexible in nature, depending on how much business development we do, that pace will either be slower or faster over time.

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

Q

Okay, okay. Maybe just to go over the pipeline for a second because there have been some huge products introduced in the companion animal space over the past three, four, five years, oral flea and tick and you guys had Apoquel and Cytopoint. When we look forward, is there the same sort of wide space from 2018 to 2022 that we saw from 2014 to 2018. I guess, the only thing that I do struggle with the component of your story is we were able to, I think, reach out and identify real opportunities in your revenue growth saying, hey, companion animal growth is going to be outsized because we've surveyed these veterinarians, there's a demand for Apoquel, for Cytopoint.

Simparica is going to get [ph] its level up in this (26:43) $1.3 billion market. It looks like looking forward, there's more of that dependency shift over to livestock, which carries with it, it seems to me, less visibility. So, is there just a whole other component to the companion animal space, like, listen, Jon, trust me, there's other things beyond that, I'm not going to share with you necessarily today. But there is other multibillion dollar – hundred million dollar opportunities to come.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.

A

I happen to believe there are. For starters, we're really small in parasiticides. And we got our fair share, in other words, a similar market share that we have in other therapeutic areas and other species. That's a huge opportunity. We see Simparica and sarolaner as a franchise. It's a single molecule today. We're looking absolutely at combos in that for dogs, for cats. So, I think you should look at that as a franchise that have great potential to grow. And so, I am personally very excited about that. And I think there's other...

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

Q

I'm sorry. Was the early-day expectations, hey, we're late to market there, we can get 10% of oral flea and tick and now some...

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.
A

Yeah. So, the guidance is on Simparica as a single agent. I mean, our view is – look, we are late and we're very late to market, I'll be honest with you, in the parasiticide space. It's been one of the largest and we've been one of the fourth largest player historically in that space. So, I think we are late to that, I think – but with a superior product, we believe our product is, it works faster, last longer. I could give you the full commercial [indiscernible] (28:04).

I think we have a great product, but we recognize we're third to market and we're going to have to work really hard to get our fair share of that. I think once we do that, when we can launch combos and continue to innovate around that product, I think that's also a pretty big opportunity. I also think it's easy now for us to say, geez, derm is huge. Clearly, we didn't think it was as big as it was. If you remember, the supply challenges we had with Apoquel, that was a space people thought steroids are fine, it's not a big market.

So, I think there's other markets like that, and one example might be pain. I still think it's a significantly underserved market. So, I think there's opportunities like that that I'm confident we can build new markets around. Derm is one that didn't exist, to be very frank with you, three years ago. So, if you'd surveyed four or five years ago, all of that be, I don't think you would have come up with it. And I believe companion animal, where more and more people are willing to spend on their pets. If you look at decade over decade, spending on pets beats spending on general consumer. I mean, it's a place, I think, going to continue to grow and if we can maintain the innovation in our pipeline that we have historically, I think we've got a really strong reason to believe companion animal would be a strong grower going forward.

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

And when you think about Simparica, sort of that platform product, where are you guys from a combo perspective? I mean, just in terms of – is that a six-month phenomenon, is that a two-year phenomenon, somewhere in between? If you can position when that next-gen product is from that platform.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.
A

We're not public about the timelines on our R&D for the same reason that none of our competitors actually are public on their timeline of their R&D. So,

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

Okay.

Kristin C. Peck
Executive Vice President & President-US Operations, Zoetis, Inc.
A

I know it disappoints many, but that is [indiscernible] (29:33).

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

And just maybe one other thing to touch on, diagnostics, so you sort of did a niche acquisition several quarters ago. It's a very compelling space. You've got – that hospital is growing 5% to 6%. I mean, diagnostics is arguably a couple hundred basis points north of that. How can you guys sort of have a bigger footprint in diagnostics? And is it something that you can use your current acquisition to build around, do you have to make an incremental investment to get there?

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

A

Yeah. So, I think the current plan, with what we acquired with SMB, with Scandinavian Micro Biodevices and what they have in their R&D platform, we do believe we can build around that. That's not to say that we won't continue to look for business development opportunities to further enhance our opportunities in diagnostics. But we are happy with what we have and with the products that we expect to come out of the acquisition...

[Abrupt End]