13-Jun-2017

Zoetis, Inc. (ZTS)

William Blair & Company Growth Stock Conference

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MANAGEMENT DISCUSSION SECTION

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We're going to get started. I'm John Kreger, the analyst at Blair that follows Zoetis in the animal health space. Thank you all for coming. Next company up is Zoetis. Juan Ramón Alaix, the CEO is here and he's going to give you an update on the company over the next half hour, and then after that we will move downstairs if you are interested to the LaSalle Room A for a breakout. In addition to Juan Ramón, Cathy Knupp, the President of R&D is also here to take part. So it should be a good discussion.

I am required to inform you that you can get a full list of our disclosures at williamblair.com. So with that, I will turn it over to Juan Ramón.

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

Thank you, John. Hello, good afternoon. Very pleased to be here again. And before I start, let me remind you that if it's – our presentation will be including some forward-looking statements that involve risk and may not represent our future results. In addition, our presentation will include a number of non-GAAP measures. You can read more about the risk and uncertainties that may affect our future results and can find a reconciliation of our non-GAAP in our SEC filings.

Today, I would like to briefly cover the first quarter results, then I will also touch on where are we in our journey as a public company and Zoetis as a leading animal health industry – animal health – leader in the animal health industry. I also want to discuss about the advantages that we have built to support our leadership and also to generate revenues and profitable growth. And finally, I will also discuss how are we investing to protect our future revenue growth.

So let me start with the first quarter results. In the first quarter, we reported 6% operational growth and this 6% if readjusted for the SKU rationalization and also some changes in our execution model, the growth will be 8% that we believe it's again faster than industry growth. And we also reported 10% adjusted net income growth. So both are consistent with our value proposition of growing revenues in line or faster than the market and adjusted net income faster than revenues.

The revenue growth came from many different sources. The introduction of new products, also emerging markets showing very positive growth and also very important diversification of our portfolio. We're also reporting our growth on both international and also the U.S. segments, we're reporting very positive growth.

As part of the information that we provided during the first quarter, we raised our guidance for Apoquel and Cytopoint. It's our dermatology portfolio and now we are targeting that in [ph] three years' (03:44) time, this combination of two products, Apoquel and Cytopoint, will generate $400 million to $500 million in revenues. We're also pleased with that all the actions that we're targeting as part of our operational efficiency programs has been well implemented and we'll see the impact of these actions in the result of 2017.

Now, let me discuss about where is Zoetis in our journey as a public company. And when we think about Zoetis and when we start back in 2013 and now, we see three different stages. So the first stage was the launch of Zoetis and also building the infrastructure as a standalone company and this was a significant undertaking that required a lot of work to separate from Pfizer in where we had part of this company for more than 60 years. So we needed to establish our own processes, IT systems, manufacturing network at the same time. So we went through an IPO that it was very successful and generating a significant value to our shareholders.

So, the second stage of our journey was when we launched our operational efficiency program. It was mid-2015 and what we identify as an opportunities to improve our operations was first to reduce our complexity. We're operating with too many SKUs, too many countries, maybe with an organization that it was not really developed to address the needs of the customers and the future needs of the company. So we decided to reduce complexity and also to improve the way that we are allocating the resources. As a result of all this work, also we identify an opportunity of reduce our cost by $300 million and I'm very pleased to report that we will be exceeding this $300 million target that we initially identified as an opportunity as part of this operational efficiency program.

Now that we have completed all this second stage, we are – we enter in 2017 with what we think is the company that we envisioned when we separated from Pfizer back in 2013. We have all the strength, we have all the capabilities. We have also all the efficiencies that in our opinion will protect and will position us for success in the future.

So let me maybe describe what we have demonstrated in this four years as a public company. And the first thing that we have demonstrated is that the animal health industry is a very attractive segment, segment which is very different than human health. Many of the animal health companies are still part of human health companies. But we think that in this four years, we have demonstrated that, it is a distinct area of opportunity and we have many things which are different compared to human health, starting with that in our business.

We don't have third-party payers. And this is something that also create a completely different dynamics for generics. Also, we have a different approach in terms of R&D and where we are combining new product innovation and also lifecycle innovation, because generic competition has a different impact in our business. So, this is something that in our opinion now many investors understand that is a good opportunity for investing in a different segment, which is also showing a steady and predictable growth. And this growth is supported by strong fundamentals, which is related to the people growing in the world, also middle class increasing in many markets and also the urbanization of people moving from rural to cities and where also is driving completely different approach in terms of diets, how to raise animals and also the adoption of pets.

There are other things that we have demonstrated. We have demonstrated that we have a business model that is delivering very strong results and I will have the opportunity to describe this business model in more detail. We have also demonstrated that while we were managing the complexity of this operation, we were able to deliver significant margin improvements and I will show also what has been the evolution of our margins in the last four years. And also we have demonstrated that we have been delivering our value proposition to shareholders. We provided this proposition at the beginning of our journey and we have been very consistent in showing that we are growing in line or faster than the market. We are growing adjusted net income faster than revenues but we are investing in value-added opportunities and we are returning excess capital to our shareholders.

So, let me now discuss about details of our business model. And our business model is based in three interconnected capabilities. The first thing is that we want to make sure that we have direct access to our customers. And through this direct interaction with customers, we generate demand. We operate now with our direct model in 45 markets, but these 45 markets are generating 95% of our revenues. We still have another 55 markets in where we commercialize our products through distributors and this represent another 5% of our revenues.

The second element of our business model is ensuring that we have the right investment and the right profitability and return in terms of R&D. And we are very pleased with how R&D is delivering and how much have been delivered in the last year. In 2016, we invested $370 million and we received more than 170 product approvals. And this 170 product approvals is a combination of new product innovation, products like Apoquel, Cytopoint that have been representing a significant blockbuster opportunity for Zoetis and meeting real needs of our customers in the market, but also we have been investing in lifecycle innovation, like the continued investment in our [ph] vaccine line (11:40). And in 2016, we also updated our Vanguard line for companion animal. We also continue investing in Draxxin, an anti-infective, which is in livestock and many other products that we continue investing because these product, they have long durability in the market and even losing exclusivity, they still generate revenue growth.

In terms of manufacturing, which is our third interconnected capability, we operate in 25 manufacturing plants, which are located in many different markets and we also place people in R&D together with manufacturing to ensure that the transition from our labs to [ph] bigger scales (12:31) is done faster and without surprises and the products can reach the market fast in terms of this transition from the labs to the manufacturing.

We have been as part of our manufacturing efforts, also expanding our presence in some of the therapeutic areas, ensuring that we have the right capacity to address the future needs of the company but also adding new capabilities, like the one that we added recently with the launch of monoclonal antibodies. So we invested in developing the capabilities for producing monoclonal antibodies in Lincoln, Nebraska and now we are very pleased that this investment is also generating extremely good support for the launch of Cytopoint.

And we will continue also in terms of manufacturing assessing all opportunities of investing in other markets like China, in where we see now the opportunity of having full ownership of vaccines manufacturing plant that in the past we had some limitations because the authority were limiting the ownership of foreign companies to a maximum of 49%, now this has been liberated and companies they can invest in vaccine plants in China and owning these vaccines.

So this slide is showing the result of many years of investment in R&D and also is showing how durable are our products, even product that has been in the market for many years, they continue growing and you see on the slide that the average span of the top 24 products in our portfolio, that has been in the market for now 30 years.

And we have even products in our portfolio that they were part of our – the first year of animal health, Zoetis Animal Health back in 1952, that in 2016 they are still generating growth. So this is something that is unique and, as you see, is not comparable to human health business, in where when you lose exclusivity the first year, you may also have an impact up to 90% of your revenues.

The work that we have been doing, it's reflected in our position in the market and we have very strong position in many different dimensions. We have very strong position, number one or two in terms of geographies, also very strong position in terms of product categories, mainly the area that we see additional opportunities in the parasiticide that now with the launch of new products like Simparica, which is an oral parasiticide, also Apoquel, also the acquisition of Abbott. We are gaining momentum on company animal and we expect also that the parasiticide and other areas of the company will be supporting our growth in this segment.

Poultry is an area in where we see that our position, it's not one or two as many other segments. But we are also investing in poultry to make sure that we are bringing new vaccines that will be very complementary to our portfolio today will increase our share in this segment.

So now let me move of what has been the evolution of Zoetis in the last four years. You see that we have been very consistent in terms of revenue growth. This revenue growth has been every year faster than the market. You see that in 2016, we are showing a 5%. This 5% was affected by the impact of SKU rationalization and also the change on some of the distribution in certain markets. Excluding the impact of SKU, and this change in distribution will be growing about 8%. So, again, very consistent growth.

And the other thing that is also important in this slide, it's how has been the evolution of EBIT margin, adjusted EBIT margin from 2013 to 2016 and 2017. So, we are targeting that in 2017, we'll be delivering EBIT margin of 34% to 35%. So we are showing here the average of this range, 34.5%. So a significant improvement, have been the result of our efforts in terms of revenue growth and also in terms of being more efficient and generating savings.

But it's important to understand that these savings has been not at the expense of having a negative impact in our future. We are convinced that now that we have generated all this profitability, we are in a better position to continue investing in Zoetis and continue investing in areas that would generate future growth.

And let me share the areas that we think are priority for us in terms of investment, it's a priority to continue investing in R&D. We want to make sure that the next generation of innovation in companion animals and livestock will be coming from our internal efforts, but we also understand that these internal efforts need to be complemented with a correlation with other companies, other universities, other R&D center and we are in very strong position to be the partner of choice for this type of collaboration. So we are extremely happy and also confident that the result that we saw in the past in terms of R&D also will continue bringing new growth and products into the market.

The second investment is in terms of commercial. We have to make sure that we maximize the revenues of new product launches. And one of the decision that we made in 2017 was to invest in DTC campaign for Apoquel and also Simparica. We even defined opportunity of increasing the awareness on dermatology issues in the U.S. and ensuring that pet owners with dogs affected by these medical conditions they know that there a solution now in the clinics, in the veterinarian clinics to treat and also to eliminate the symptoms of many of these medical conditions.

And this advertising campaign is focused on Apoquel, but at the same time, we know that this also will have a positive impact on Cytopoint. What we know is that if we bring patients to the clinics, they will leave with either Apoquel or Cytopoint because they are the best two products to treat these medical conditions.

We also started DTC campaign for Simparica, the oral parasiticide and we had very good results in the first quarter even before the introduction of DTC. I will see how this DTC is supporting our growth for Simparica. We're also considering the need of expanding our field force, our presence in some of the emerging markets or some of the markets, which are showing very positive growth.

We expanded our companion animal field force in China and we're also expanded our companion animal field force in Brazil and we are now expanding our livestock cattle field force in Brazil too. We also [ph] have identified (21:22) as second priority in terms of capital allocation, external acquisitions and we have been doing that with acquisitions like PHARMAQ in 2015, in where we acquired a company in the fish segment, an area that we see significant opportunities for growth, an area where we didn't have presence and the acquisition of PHARMAQ is bringing a very strong portfolio in vaccines, in where we see the biggest opportunity in terms of PHARMAQ fish.

We also announced we acquired a company in Denmark, it was a company for diagnostics, for equipment. It's a company called Scandinavian Micro Biodevices. And this company is bringing to Zoetis a technology for diagnostics based on microfluidic that it can be a significant opportunity in terms of bringing new products into a market, which is growing faster than the average of the animal sales industry. And we see the opportunity of complementing our activity, our interaction with customers with diagnostic tools.

We also announced that we are in the process of acquiring Nexvet. Nexvet also will bring to us monoclonal antibodies that will be targeting different therapeutic areas, including pain for dogs and cats, and will be very complementary to our effort that we develop with Cytopoint in monoclonal antibodies.

So definitely, we see M&A as additional opportunity for generating that growth. We have a lot of experience in terms of integrating companies and maximizing the value of these acquisitions, either in terms of sales synergies or cost synergies.

And then, we also have the commitment of returning the excess capital to our shareholders. As I said, priority number one will be investing in internally because we have been seen significant return of this investment, M&A, but then also we know that we'll be generating excess cash that we will return to our shareholders.

We already announced an increase on our dividend policy by 10.5% at the beginning of 2017. We also completed the first program of $500 million of buying a share back and the board approved last year a new program of $1.5 billion multi-year program of buying shares back.

And on top of that, as part of our policy, we are also defining leverage ratio of 2.5% to 3% (sic) [2.5 to 3], and you see on the slide in absence of M&A. So we don't want that we are missing any opportunity that will be supported by the right financials and also by the strategy to incorporate other companies, other assets that will generate a growth and value to our shareholders.

And let me finish with the comment I made at the beginning of my presentation in terms of what we have demonstrated, in terms of our value proposition to our shareholders. We are committed to continue growing in line or faster than market in revenues. We are committed also to generate profitable growth and growing adjusted net income faster than revenues. We'll continue assessing the opportunities for investment that will create value to the company. And as I said, we'll be returning excess capital to our shareholders Thank you very much for your attention.

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

Thanks very much. If anyone who wants to take part in Q&A, we would do it in LaSalle Room A. Thanks.