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Zoetis, Inc. (ZTS)

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CORPORATE PARTICIPANTS

James K. Saccaro
Executive Vice President, Chief Financial Officer & Chief Operating Officer, Zoetis, Inc.

MANAGEMENT DISCUSSION SECTION

Unverified Participant

Thanks, everyone, for joining. We have Jay Saccaro, CFO and COO of Zoetis here with us today. Thanks for coming to London.

James K. Saccaro

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

Yeah, thanks so much for having us. We appreciate it. And thanks to those joining us in these tight quarters. We appreciate you all taking time out of your day to learn more about our company.

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Yeah, we have 25 minutes, a lot to get into.

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QUESTION AND ANSWER SECTION

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Maybe just start with kind of your first 90-days or so, you've been there, you've been meeting some customers. It's just helpful to understand where you're spending most of your time. How are you getting up to speed and maybe just what surprised you the most in your initial 90 days versus what you observed from the outside?

James K. Saccaro
Executive Vice President, Chief Financial Officer & Chief Operating Officer, Zoetis, Inc.

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So, here's the good news. The good news is no real surprises. When I joined the company, I believe that this is a great company whose best days are ahead of it. And the reason I believe that, we have a great leadership and management team. We have an incredible pipeline, incredible commercial organization and manufacturing and supply chain organization. So, we have so many great assets that my view was the opportunity to unlock value was there and that we would be able to do this in the coming years. For me, coming in, so many of the things I've seen have been confirmatory. I'm spending a lot of my time really understanding the financials, understanding the business, understanding the manufacturing processes and our customers, also digging into the pipeline in great depth. And what I can tell you is all of that work has generally confirmed some of those initial theories, which is just really nice to see.

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Okay, that's helpful. Kind of follow-up to that. In terms of given what you've seen, where do you think the biggest opportunities are at Zoetis? I think there's been some commentary about the commercial effectiveness. You mentioned the cost structure, just where you kind of see, kind of the lowest hanging fruit?

James K. Saccaro
Executive Vice President, Chief Financial Officer & Chief Operating Officer, Zoetis, Inc.

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Sure. I think that the biggest opportunity that we have is innovation and the pipeline. We have the opportunity with respect to our existing markets to launch, differentiated product offerings based on new science and to enter completely new areas based on the pipeline work that we've done. And so, I think that's a huge opportunity. Now having said that, we're a world-class manufacturer and supplier of products.

So, I think we have a great opportunity in terms of continuing to drive down the manufacturing costs of the product that we make on a daily basis. And then finally, as I said, we have a really good commercial footprint. We sell in over 100 countries around the world. And we have outstanding relationships with all of our major customers. And so, from our standpoint, really taking advantage of that commercial organization and being very thoughtful about the promotions that we pursue, that's another real opportunity for us. But make no mistake, the biggest thing for us as we look to the future years comes down to this pipeline.

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Okay. I want to pivot to the macro, I guess, which is a hot topic for a lot of people and I think it'd just be helpful to kind of level set kind of what you're hearing from the clinics, what you're hearing from pet owners. We're kind of

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coming off of this pandemic cycle and just kind of understanding where you think we are in the cycle and just the macro environment in general would kind of be helpful to start there.

James K. Saccaro
Executive Vice President, Chief Financial Officer & Chief Operating Officer, Zoetis, Inc.

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Sure. And maybe, maybe before we get into some specific short-term dynamics, the one thing I would say is during our earnings call, we pointed out a couple of interesting things with the Human Animal Bond Institute (sic) [Human Animal Bond Research Institute] (00:04:03), some of the work that had been done there. And it turns out that 98% of pet owners point to their pets contributing positively to their emotional or physical well-being. Okay. It's a huge deal. And by the way, as a dog owner, when I see pictures of my dog, it makes me happy. Okay. And of those people, 91% said they would be willing to spend on their pets health because of these benefits that they feel that they're receiving. Now, I know you're not a pet owner yet. I have hopes for you. Okay, I do. I have hopes for you. But the reality is you have this great long-term tailwind, which is owning pets is a great thing. And by the way, there's a second dynamic, too, which is, if I were to ask the room a question, what percent of the people had a protein shake today or is focused on their protein consumption at some point during the day, I will tell you, I think everybody in the room would raise their hand. So, there's a long-term tailwind supporting protein consumption. So, you put these two tailwinds together and overall, the story with respect to our two lines of business is solid.

Now we are seeing some pressure in the short term, and we've discussed this extensively. There's a few things, right? There's – the veterinary service costs is up, I believe, 40% or 50% since 2022. So, it's a very big increase in the cost to serve. In addition to that, you have a willingness amongst GenZ and Millennials to switch how they get their products, what – be it channel, be it service provider, creating some intensity there. At the same time, homeowner affordability is another questionable area where there has been some pressure. And what that's leading to is in some cases, smaller homes, which leads to things like cat purchases versus dog purchases. You could get a cat because you live in an apartment in Manhattan. But the point is cats are under medicalized relative to dogs. And so, you have that phenomenon as well.

So, there are a few factors that are in play that we have to be mindful of. But I get back to what are the major tailwinds supporting this business. They're very big, right. This human animal bond thing is enormous and this idea around protein consumption, these two tailwinds, I think, are inexorable, unignorable and they will continue to drive the business going forward.

But in the meantime, we have seen some pressure and we'll talk – I'm sure we'll talk about visit metrics and things of that nature that we've seen some pressure on these things, so we watch this very closely. And importantly, as we think about things like our guidance, we're not assuming any changes to these dynamics, so we're not counting on a change in trajectory. We're going to assume, like this pressured environment continues. But generally speaking, I do believe there is cause for hope because of some of these things that I've mentioned.

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Okay, that's helpful, I think. Maybe focusing on the short-term kind of pocket you're talking to the pressure. I think at 3Q, you guys ran some targeted promos, some price investments. I think it would just be helpful to kind of hear what worked, maybe what didn't work as well as you would like, how you're trying to change it in 4Q and beyond, just to try to navigate today's environment a little bit better.

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James K. Saccaro
Executive Vice President, Chief Financial Officer & Chief Operating Officer, Zoetis, Inc.

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Sure. So, it's been a fairly intense competitive environment and what we've seen at the highest level in the third quarter, our price was down a point, maybe a little bit more than a point and volume was flat, which in a challenging market with the competitive landscape that we're seeing, that's not a bad outcome. And in fact, from a revenue standpoint, we came in where we hoped for it to be perhaps a little bit better. So overall, things were moving ahead according to our expectations.

So, generally, our promotional strategy worked. Now what we did for the most part, our promotions were focused on temporary rebates, discounts, incentives either for customers or vets to trigger purchases. There were a couple of instances where we made a permanent price adjustment to products, so in the case of Convenia, where we've seen some incremental competition and another product, Cerenia, where there was a generic competitor as well. In the case of those two product areas, we made a structural change to price, but everything else was about sort of specific promotion and I would say generally speaking, they moved ahead according to our expectations. And the nice thing about this is you can turn them on and off with a great degree of flexibility.

And so, as we look at the landscape next year and we think about what we're trying to achieve, we may choose to do promotions in the future, we may not. And it will all depend upon how things are going from a share standpoint and things of that nature. What I would say is our goal was to mute some of the impacts that we were seeing. And what we saw in the third quarter is, for example, in dermatology, in the second quarter, we lost a fair bit of share, we lost around 7 points of market share, which was a fairly substantive move. In the third quarter, it was down to 4 points, so we reduced that basically in half.

In the case of our parasiticides business, we really were able to defend share in the quarter in a good way. And so, what I would say is I think promotions are a great tool to have in our toolbox. We will use it judiciously over time. I think for us, we're much more reluctant in terms of broad scale price change that's permanent because that has other implications. But I think, as we look at the market share landscape and then also with respect to each area, the innovation landscape in that area will use promotional tools to kind of support our business objectives.

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Okay, that's helpful. You already started talking about the portfolio, which is where I wanted to go next. And I guess, when I think about the core, the parasiticides, the dermatology, there's been competition that has come into the fold. They've been taking some incremental share. Just how do you think about your competitive position today in those two areas and how should we think about, I guess, the new formulations that are coming to market? I know you had Cytopoint Plus approved last week, just the competitive position and then I think the new formulations, how it's all kind of meant to work and how you feel about the core today?

James K. Saccaro
Executive Vice President, Chief Financial Officer & Chief Operating Officer, Zoetis, Inc.

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So, first, we feel very good about the existing products that we have in the market. We feel that they've been in many cases on the market the longest, with the largest body of research supporting them. In many cases, they are considered to be the standard of care. So, we feel great about that. Now, but at the same time, with competitive offerings coming to bear and you have those challenges in place, we're not going to stop innovating in the base business. I've talked a lot about, extensively about some of the new innovative areas, which maybe we'll talk about later, things like Oncology and CKD and things of that nature. But we're also going to focus our

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innovation efforts squarely on our existing portfolio and that is new and different formulations, extended duration, those kinds of tools are the things that you focus on to really differentiate in that business.

And so, we were thrilled that Cytopoint Plus was approved, and so excited about what that will bring to market. We anticipate launching this product in the first quarter of the year, that's our expectation. We'll be thrilled to bring that to market. It's the longest acting product with respect to injectable dermatology treatments at 75-days. So, it's a significant extension versus what we currently have on the market and I believe what competitors offer.

So, really excited to bring Cytopoint Plus to the market in the first quarter and that's how you differentiate in the existing franchise. On the parasiticides, we have another one coming on – in Simparica Duo, we expect approval for that shortly. And in the case of Simparica Duo, basically for flea, tick, and heartworm, a lot of times either heartworm is not an issue or heartworm is such an issue that it requires a very specific treatment.

Hence the notion of a trio product is less relevant. So, we are offering Simparica Duo, which will have play in two markets, those two markets that I just described, and it's just another sort of auxiliary offering that we can bring to bear that should help differentiate the existing portfolio. So, as I think about how do you win in a competitive environment with your existing portfolios, it comes down to some of these innovations that I just discussed, commercial excellence, making sure we have the best and most diverse portfolio, but also a great sales team. And then thinking creatively about how we promote and distribute the product.

Q

Okay. That's helpful, I think. You already touched upon kind of the pipeline to come. You talked about Oncology, CKD, just, I think want people want to get their arms around is how we should think about the pace of the new launches in today's macro, is there sufficient demand, I guess, that will be receptive to this innovation and just kind of how you think about layering that on into the market in the coming years?

James K. Saccaro
Executive Vice President, Chief Financial Officer & Chief Operating Officer, Zoetis, Inc.

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Yeah. So, listen, we've learned a lot about how to effectively launch products and I think it's a less about macro and it's more about how do you ensure you're building the support so that this is an overwhelmingly positive launch and a positive experience for your patients, customers, vets, et cetera. And so, we're going to be mindful of, go slow to go fast. But at the same time, you start – you get the launches going and then you start stacking them up. And we will have a steady stream of innovation. Exhibit A, Cytopoint Plus, that will start to impact results in 2027. But we will have CKD as an opportunity impacting 2028, oncology impacting future years.

So, we will stack these up and it will be a steady stream of innovation. Now here's the interesting thing, okay, CKD is the number one cause of death in cats. CKD, I think roughly 20% of dogs and 40% of cats will contract CKD at some point in their lives. And CKD, the total addressable market is, I believe, $3 billion to $4 billion. Okay. So, this is a huge opportunity. And by the way, it's totally blue ocean because it's unaddressed today. So for a pet owner, this is an opportunity to extend life. And for vets, it's an opportunity to create new revenue. So, it's a really nice opportunity.

Oncology is a $1 billion to $2 billion market. Again, I think the number one cause of death amongst dogs is oncology, this will be a treatment for that. And then we have the others, anxiety. My dog gets stressed out a lot. Okay, so I'm thrilled – actually thrilled for it to have an anti-anxiety product available. So, we have that, we have cardiology products coming. So, the notion of getting a stream of innovation launched and it starts now is

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something that's incredibly exciting for us. 2027 will benefit from the continued launch of Lenivia and Portela, which are long-acting pain meds plus Cytopoint Plus. But then you start to back this up with some of the new areas that will be entering. I get incredibly excited about what this business can do in future years.

Q

It's helpful. I think Zoetis has always been known as, investing a lot in R&D. And I think just given you joined, you're taking a fresh look at the business, maybe just your thoughts on capital allocation today, reinvestment versus there's been consistent buybacks, a little bit of M&A here and there. Just your thoughts on the priorities in today's environment?

James K. Saccaro
Executive Vice President, Chief Financial Officer & Chief Operating Officer, Zoetis, Inc.

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Yeah. So, from my standpoint, reinvest in the business to win. So, we want to be incredibly diligent about spending about variable costs and all of these things. But at the same time, we want to fund R&D for success. One of the things, probably my favorite week on the job so far was the week I spent in Kalamazoo, Michigan, reviewing the exciting pipeline that we have. It's awesome. It's an awesome pipeline and we want to fund that for success.

So, reinvest in the business both in terms of CapEx and R&D. Once you've done that, then we definitely want to pursue M&A. But I think generally and structurally, the opportunities from an M&A standpoint are more about tuck in than anything more substantial than that. We have bought a lot of stuff over time and been a successful acquirer. We'll continue to do that. And then we'll look at, continuing to maintain or grow the dividend and buybacks. In the third quarter, we repurchased $0.5 billion in shares. I think on a full year basis between so far this year, between buyback and dividend, it's over $2 billion in terms of return of capital to shareholders, which is something that we appreciate. I like to buy shares when they trade at a discount to the intrinsic value. And as we look at it today, like the shares represent a real opportunity and a real vehicle for us to return capital to shareholders in an economically attractive way.

Q

Okay. I think maybe it started a couple of quarters ago, but there was some mentions of retooling, restructuring, kind of reprioritizing the business a little bit. I just, maybe want to just get your take on, is there like a bigger cost or efficiency program coming? Should we expect to see a formal savings target? I know that there's been some shifts in the business in terms of how it's operating, but I just wanted to get your view on how the business is set up today for the go-forward?

James K. Saccaro
Executive Vice President, Chief Financial Officer & Chief Operating Officer, Zoetis, Inc.

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Yeah, I mean, what I would say is, there's always opportunity. We'll be incredibly disciplined on the cost side. But think about the margins that we have at this point, 70% gross margin, 40% operating margin. This – the business free cash flow is incredibly well. This is a very, very good business. So, while I agree and believe that there are opportunities for further optimization of cost, it's not like we have a margin that's really challenging. The real question for us is how do you continue to grow or get to growth so that you can support this great economic engine that you have? Now, having said that, we have done restructuring. We've talked about this in the past. In the third quarter, SG&A grew 0%. In the third quarter, the gross margin was down, I think year-over-year, 20 basis

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points or 30 basis points in the face of a price decrease of 1%. How do you manage that? Well, you manage that through having great productivity initiatives in our network. And so, we're going to be intensely focused on every dollar of SG&A is a dollar well-spent. We're using AI, we're being thoughtful about replacements, we're replacing in low cost locations, all of those things. And there will be further opportunity.

On the gross margin side, this is really about year-over-year cost out. One of the things that one of my former employers – we were intensely focused on a business system to drive profitability improvements and really delight customers. But that was so much focused on the manufacturing network in those productivity initiatives. We have that same intensity and we're really driving that right now, expecting cost down year-over-year. Because, listen, I believe we're the – we are the best manufacturer in the industry. Now, others may contend differently, and that's okay. But I believe that and that means cost down year-over-year. And in an environment where there might be price challenges in the future, having cost down year-over-year gives you a huge advantage to the extent that you're able to engineer that. So, that's what I would say, in terms of cost, extremely disciplined, continued focus on SG&A. There's more opportunity there and also real opportunity on cost down from a manufacturing standpoint. As we look at R&D, we'll continue to fund that for success.

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Okay. I think on the earnings call, you mentioned the word prudent in terms of planning for 4Q and 2027, maybe just remind us kind of your main assumptions in terms of the macro, the volume, the innovation. We've touched upon a lot of it, but the word prudent makes it seem, you had a specific set of assumptions that are going into how you're thinking about the business and 4Q and beyond. So, just if you could just lay those out for us, I think would be helpful.

James K. Saccaro
Executive Vice President, Chief Financial Officer & Chief Operating Officer, Zoetis, Inc.

A

Yeah, I think and we didn't – we stopped short of getting into specific details. But I think what we committed to is we're not going to assume a change in trajectory of the macro environment. Okay. In the third quarter, we had a decline of, I believe it was 3% or 4% in overall visits in terms of pruritus visits, which are dermatological visits, it was 3% to 4% in the US, these are US numbers and flea, tick, heartworm was down double-digits like 10% visits.

And so, we're not going to assume a change in trajectory in those numbers. We also had assumptions in terms of the competitive environment. So, we saw – while the share was steady in the Simparica area, we did lose share a few points in dermatology and the environment has been a challenging one. We're not going to assume a change in environment as we go to next year. And then as it comes – as it relates to innovation, I hope you walk away from this presentation, recognizing how excited I am about the long-term. At the same time, we are not counting on, we're not going to count on a huge impact from innovation in 2027. It's more going to be about 2028 and 2029. There will be some, make no mistake, but really the lion's share of the impact starts coming when you have a full year of Cytopoint Plus, you start entering some of these new areas 2028, 2029, 2030. So, we're not going to try to front run or assume something aggressive on the innovation front.

Why that's important, it just sets us up to really have a very successful year. Once we set this, once we put those assumptions in place, I believe we have opportunities to really get the building blocks in place for this incredibly successful future. As I said at the beginning, this is a great company. I'm convinced of that now having spent three months. Great leadership team, great products, wonderful innovation pipeline, world class manufacturing. And I believe that the best days are ahead of us. But it's all about, getting from here to there and setting things up correctly. I think we did that with the rest of the year guidance. I think we've got the right pieces in place. And then

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as we go to next year, we'll have those guiding principles that I described that I think will set us up in the right way.

Unverified Participant

Awesome. I think we're at time. Jay, thanks for sharing your insights on the business. Appreciate it.

James K. Saccaro

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

Thank you so much.

Unverified Participant

Thanks.

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